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# Predatory Pricing in the Courts: Reflection on Two Decisions

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# Predatory Pricing in the Courts: Reflection on Two Decisions

*Peter C. Carstensen\**

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## I. Introduction: Predatory Labeling

Sometimes labels are helpful in providing an initial categorization of events which gets us more quickly to the relevant issues. Legal analysis is particularly prone to using such pigeonholing sys-

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\* Professor of Law, University of Wisconsin. I am indebted to Professor Willard F. Mueller and several generations of students in our seminar in Antitrust Law and Economics for their efforts, collectively and individually, to educate me on the issues of predation. Many of the insights offered here derive from the discussions and papers of the seminar.

tems. Unfortunately, not all labels are equally helpful. Some act more like either black holes or rat holes: They either swallow the entire topic or provide nothing of analytic value. In present antitrust law analysis, the labels of "predation" and "predatory pricing" present examples of such dubious categories. It is commonly assumed that if an enterprise engages in a "predatory" act, or charges "predatory prices," it has violated either the Sherman Act's prohibitions against monopolization or attempted monopolization or, at least, contravened some other part of the antitrust laws.<sup>1</sup> For this reason, courts and commentators have elaborated on the definitions of these terms.<sup>2</sup> But in so doing, these authorities have made little or no effort to link their definitions to any analysis of the law of monopolization.

There is in fact no express basis in any statutory language for declaring that a "predatory" price is unlawful.<sup>3</sup> Nor does a label of predation have any clearly defined relationship to a component of any section 2 cause of action. The current preoccupation with whether a price or other conduct is "predatory" in the abstract, therefore, suggests a lack of legal analysis.

In general, terms should take their meaning from the context of their use. Hence, before defining what "predation" is, lawyers ought to have a clear idea of the legal relevance of the term. In addition, if courts and litigants propose to use economic concepts, they ought to use them correctly. Yet, recurrently, the cases suggest either a misapplication of economic theory itself or a misunderstanding of the relationship of data to theoretical concepts. Such misinterpretation further confuses the analysis of predation. That the results reached in many cases seem to yield acceptable outcomes should provide not consolation, but rather, consternation—since the process suggests that the theories of predation might, absent misapplication, have produced less desirable results.

In this article, I plan to illustrate and develop the foregoing propositions. In Part II, I will identify some of the possible connec-

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1 See P. AREEDA & D. TURNER, 3 ANTITRUST LAW ¶ 711 (1976).

2 See *id.* See also R. POSNER, ANTITRUST LAW, AN ECONOMIC PERSPECTIVE 184-96 (1976); Brodley & Hay, *Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards*, 66 CORNELL L. REV. 738 (1981); Dirlam, *Marginal Cost Pricing Tests for Predation: Naive Welfare Economics and Public Policy*, 26 ANTITRUST BULL. 769 (1981); Scherer, *Predatory Pricing and the Sherman Act: A Comment*, 89 HARV. L. REV. 869 (1976); Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977); Zerbe & Cooper, *An Empirical and Theoretical Comparison of Alternative Predation Rules*, 61 TEXAS L. REV. 655 (1982).

3 This is true of all relevant statutes except, arguably, for an unused portion of the Robinson-Patman Act which is not even technically part of the antitrust laws. Robinson-Patman Act § 3, 49 Stat. 1526 (1936) (codified at 15 U.S.C. § 13(a) (1982)) ("It shall be unlawful for any person . . . to sell . . . goods at unreasonably low prices . . ."). This section is not included within the definition of the antitrust laws found in section 1(a) of the Clayton Act, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. § 12(a) (1982)).

tions between labeling activity "predatory" and relevant legal and economic issues in various kinds of monopoly cases. I will also identify some of the issues that arise in both understanding and applying economic definitions in litigation. In Parts III and IV, I shall discuss two recent circuit court decisions<sup>4</sup> which illustrate concretely some of the consequences of a poorly informed search for a predatory price. This case analysis will lead me to offer some further adverse reflections in Part V on the use of the label "predatory pricing."

## II. The Legal and Economic Issues in Relating Predation to Monopolization

### A. *Legal Implications of a Claim that a Price is Predatory*

Most courts and commentators proceed as if they clearly understand the legal significance of a finding of predation; yet, nowhere in the Sherman Act is it said: "No person shall charge a predatorily low price."<sup>5</sup> We must look elsewhere to find the linkage between predatory pricing and the offenses defined in the Sherman Act.

An analysis of the history of labeling conduct "predatory pricing" is not illuminating. Predatory pricing was a pejorative label inserted in opinions without definition.<sup>6</sup> To be sure, Congress in adopting the Sherman Act had a fairly clear legislative intent to forbid monopolists from creating or preserving monopolistic positions by unlawfully exclusionary conduct.<sup>7</sup> One might therefore call all exclusionary conduct "predatory," but that begs the definitional question: All effective and successful competitive conduct has some actual or potential exclusionary effect and the successful competitor is aware of these consequences.<sup>8</sup> Such "intended" harm to competitors cannot, without more, violate the antitrust laws. Hence, it is necessary to define what conduct is "unlawfully exclusionary." While "predatory" may be a synonym for "unlawfully exclusionary," it is hardly a definition.

Professors Turner and Areeda triggered the contemporary policy debate over predation with an article containing legal analysis which is ephemeral at best. They simply asserted:

A firm which drives out or excludes rivals by selling at un-

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4 See notes 67-68 *infra* and accompanying text.

5 See note 3 *supra* and accompanying text.

6 See, e.g., *United States v. American Tobacco Co.*, 221 U.S. 106, 182 (1911).

7 See W. LETWIN, *LAW AND ECONOMIC POLICY IN AMERICA* (1965); H. THORELLI, *THE FEDERAL ANTITRUST POLICY* (1954). See also R. BORK, *THE ANTITRUST PARADOX* 68 (1978).

8 Cf. *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 430 (2d Cir. 1945) (Hand, J.) ("The successful competitor, having been urged to compete, must not be turned upon when he wins.").

renumerative prices is not competing on the merits, but engaging in behavior that may properly be called predatory. There is, therefore, good reason for including a "predatory pricing" anti-trust offense within the proscription of monopolization or attempts to monopolize in section 2 of the Sherman Act.<sup>9</sup>

Turner and Areeda's argument assumed that the firm charging the predatory price was a monopolist with a given quantity of market power and position.<sup>10</sup> The authors then asked how low a price (relative to different cost measures) such an enterprise could charge before its conduct became unlawful.<sup>11</sup> Their analysis also assumed that, even in the context of an otherwise lawful and apparently invulnerable monopoly, antitrust law ought to limit the monopolist's pricing discretion—even if the law was unwilling or unable to remedy the power itself. In a sense, then, Professors Turner and Areeda were advancing a mildly expansionary definition of the duty which the Sherman Act imposes on a monopolist.<sup>12</sup>

The scholarly and judicial response to Turner and Areeda's article consists almost entirely of economic analyses of pricing or other conduct without legal analysis of the significance of the conclusory "predation" label itself. Yet, in their treatise, which reasserts their predation argument, Turner and Areeda preceded their restrictive definition of predation with a section in which they argued that any *remediable* monopoly ought to be "unlawful"—regardless of its conduct—if it was "persistent" and its power "substantial"; but the remedy then should be exclusively equitable and aimed solely at dissipating such power.<sup>13</sup> Such a conclusion demonstrates that Turner and Areeda saw the predation issue as involving *only* the question of the lawfulness of particular conduct by a monopolist when challenged in a criminal or damage action, *i.e.*, an action which did not challenge the lawfulness of the monopoly position itself.<sup>14</sup>

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9 Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

10 See *id.* at 701-02, 704-09.

11 *Id.* at 709-16.

12 An alternative and more plausible response would have concluded that since the pricing decision did little to entrench or prolong the monopoly, it was not "monopolization." Cf. *Paschall v. Kansas City Star Co.*, 727 F.2d 692 (8th Cir.) (en banc), *cert. denied*, 105 S. Ct. 222 (1984); *Official Airline Guides, Inc. v. FTC*, 630 F.2d 920 (2d Cir. 1980), *cert. denied*, 450 U.S. 917 (1981).

13 P. AREEDA & D. TURNER, *supra* note 1, ¶ 623.

14 A major source of Turner and Areeda's concern with sweeping definitions of predation was the risk of private damage claims. See Areeda & Turner, *supra* note 9, at 699. See also Areeda & Turner, *Scherer on Predatory Pricing: A Reply*, 89 HARV. L. REV. 891, 894 (1976). The problem is illustrated by *Telex Corp. v. IBM Corp.*, 367 F. Supp. 258 (D. Okla. 1973), *rev'd*, 510 F.2d 894 (10th Cir.), *cert. dismissed*, 423 U.S. 802 (1975). In *Telex*, the plaintiff, an apparently inefficient producer, had proven that the defendant, IBM, had cut its prices to a level which would eliminate plaintiff from the market although IBM's prices remained fully

Taking the body of case law and writing as a whole, I discern three distinct types of claims under section 2. First, there are cases in which the lawfulness of the *market position* of the firm is at issue. If it is an unlawful position, the law authorizes a remedy aimed at eliminating such monopoly power.<sup>15</sup> But it is generally said that "monopoly in the concrete"<sup>16</sup> is not a violation; the monopoly must be one which, in some sense, the firm has willfully acquired or maintained.<sup>17</sup> Hence, the conduct of the firm must satisfy this test before any remedy aimed at dissipating its monopoly position is justified.

Second, there are cases in which the only challenge is to the lawfulness of *particular conduct*. This type of claim includes several variant theories of what constitutes wrongful conduct, each of which takes different account of the market position of the defendants. In some cases, the existence of monopoly power is at issue. Plaintiffs' claims are then that particular acts or practices are unlawful *for monopolists*.<sup>18</sup> Sometimes plaintiffs provide little information about the defendants' market position; in such cases, the issue is whether specific conduct is generally unlawful (as either "monopolization" or "attempted monopolization").<sup>19</sup> In still other cases, the defendants may have a substantial, but less than monopoly, position which is said to subject their conduct to a stricter standard of review.<sup>20</sup> For each of these variants, the issue remains the lawfulness of the defendants' specific acts in light of its lawful, or at least not unlawful, market position.<sup>21</sup>

The third type of claim also focuses on the lawfulness of specific conduct but invokes a different legal analysis of the defendant's

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compensatory and profitable. Such conduct was clearly exclusionary and so, in a sense, anticompetitive. But in a truly competitive market a high cost firm such as Telex never would have existed. The district court labeled this pricing as predatory and upheld a large damage verdict. Subsequently, the Tenth Circuit reversed that verdict.

A better focus for the concerns of Professors Turner and Areeda might be damage theory: Can a victim of above-cost pricing, *i.e.*, a price which could have occurred in a competitive market in stable, long-run equilibrium, claim damages based solely on losses resulting from such pricing?

15 *Standard Oil Co. v. United States*, 221 U.S. 1, 77-78 (1911). Such remedy may be structural or otherwise.

16 *Id.* at 62.

17 *United States v. Grinnell*, 384 U.S. 563, 570-71 (1966). See note 8 *supra*.

18 See, *e.g.*, *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 105 S. Ct. 2847 (1985); *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951).

19 See, *e.g.*, *Lessig v. Tidewater Oil Co.*, 327 F.2d 459 (9th Cir.), *cert. denied*, 377 U.S. 993 (1964).

20 See, *e.g.*, *In re E. I. DuPont de Nemours & Co.*, 96 F.T.C. 705 (1980).

21 See *id.* See also *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014 (9th Cir. 1981), *cert. denied*, 459 U.S. 825 (1982); *Telex Corp. v. IBM Corp.*, 367 F. Supp. 258 (D. Okla. 1973), *rev'd*, 510 F.2d 894 (10th Cir.), *cert. dismissed*, 423 U.S. 802 (1975).

market position. In this approach, the plaintiff claims first that the defendant has a monopoly position which is unlawful.<sup>22</sup> But then, following the second approach, the plaintiff claims only that particular conduct by such an unlawful monopolist entitles it to either damages or specific, conduct-oriented injunctive relief.<sup>23</sup>

The theories undergirding these approaches strongly suggest that each case could employ distinctive definitions of the kind of conduct which is legally relevant and objectionable. In such cases, the definition of an unlawful, "predatory" price should also vary.

### 1. Predatoriness as an Element Which Makes a Monopoly Unlawful

Despite suggestions to the contrary,<sup>24</sup> courts still require plaintiffs in cases alleging an unlawful monopoly to show both the presence of monopoly power *and* its "willful acquisition or maintenance."<sup>25</sup> Although the conduct criterion is very vague, its function is relatively clear and distinguishes unlawful monopoly cases from claims alleging that particular conduct alone is wrongful.

Conduct evidence must demonstrate the unlawfulness of the monopoly itself by showing that its possessor consciously obtained or retained the dominant position. In this context, evidence that a large firm (such as AT&T, IBM, or Kodak), without below-cost pricing or other economic loss, has excluded competitors is highly persuasive of a willful maintenance of a monopoly, especially in contexts which demonstrate that the only rational economic explanation for the conduct was to achieve such exclusion. Such evidence both demonstrates strategic behavior aimed at excluding competition and strongly suggests that the "centrifugal and centripetal forces" of the market no longer guarantee necessary limits on the firm's monopoly power.<sup>26</sup> In fact, evidence of successful exclusionary conduct which does not involve deep price cuts ought to be more persuasive of the entrenched position of the monopolist than evidence that excluding competitors from the market required a costly effort and deep price cuts. Paradoxically, the deeper the price cut, the less convincing is the claim that the putative market

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<sup>22</sup> See, e.g., *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980). Cf. *United States v. Griffith*, 334 U.S. 100 (1948).

<sup>23</sup> See *Berkey Photo*, 603 F.2d 263 (2d Cir. 1979).

<sup>24</sup> See P. AREEDA & D. TURNER, *supra* note 1, ¶ 623; *United States v. Grinnell*, 236 F. Supp. 244, 247-48 (D.R.I. 1964) (suggesting a rebuttable presumption of illegality once monopoly is shown), *affirmed in part, reversed in part*, 384 U.S. 563 (1966). See also *United States v. Aluminum Co. of Am.*, 148 F.2d 416 (2d Cir. 1945).

<sup>25</sup> *Grinnell*, 384 U.S. at 570-71.

<sup>26</sup> *Standard Oil*, 221 U.S. at 62.

power of the defendant is so substantial and dominating that a court should declare it unlawful.

The fact that a firm has willfully maintained or acquired a monopoly does not necessarily make the monopoly illegal. As Judge Learned Hand suggested, there must be exceptions for at least some special cases.<sup>27</sup> Some exceptional cases involve a showing that the challenged monopoly is a short-run phenomenon without enduring power, and therefore, unworthy of judicial concern.

Still there remains the case of a monopoly which exists because the market is "so limited that it is impossible to produce at all and meet the cost of production except by a plant large enough to supply the whole demand."<sup>28</sup> A crucial issue in such a structural monopoly case is whether the power can be eliminated without imposing significant economic costs on society.<sup>29</sup> The *availability* of a remedy for such monopoly power is crucial.

Courts can draw some inferences about remediability from the conduct needed to create and maintain the monopoly. As a monopolist requires more active, strategic behavior (*e.g.*, deep price cutting or coercion of customers or suppliers), a conduct-oriented remedy may well suffice to remove the monopoly power. Conversely, where the monopolist is able to maintain its position without employing overtly evil conduct, an effective remedy may require more direct, structural changes. But inferences from history are not persuasive, and the key issue remains focused on the expected societal costs and benefits of a proposed remedy.

This analysis suggests that it may make little sense to condemn monopoly power itself as unlawful unless it can be effectively remedied. Should a monopoly position, acquired by conduct itself clearly illegal, be tainted as perpetually illegal if a court cannot now remedy that monopoly? While allowing customers and competitors to tax such a monopolist may fulfill some noneconomic desires for retribution,<sup>30</sup> it hardly makes sense as economic policy.<sup>31</sup>

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27 *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 429-30 (2d Cir. 1945) ("[P]ersons may unwittingly find themselves in possession of a monopoly . . . The successful competitor, having been urged to compete, must not be turned upon when he wins.").

28 *Id.* at 430.

29 A firm as large as U.S. Steel has successfully invoked this claim. *United States v. United States Steel Corp.*, 251 U.S. 417, 454-57 (1920).

30 *Cf. Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 295-96 (2d Cir. 1979) (past misconduct made monopoly illegal in perpetuity and so liable for damages), *cert. denied*, 444 U.S. 1093 (1980).

31 One might argue that repeated damage awards will deter other firms from engaging in such conduct. However, those who actually did the predatory acts will have long since left the defendant firm, a fact which reduces greatly the impact of the deterrence lesson. Moreover, unending damage claims can ultimately require payments beyond any rational level of deterrence, especially when applied to a firm whose monopoly power is apparently unavoidably associated with its economic efficiency. The better method for achieving de-



In sum, the key elements of a structural monopoly case are monopoly power and its remedy. The conduct of such a firm, while a necessary element, is secondary. Moreover, by establishing restrictive definitions of the conduct element, courts will preclude themselves from dealing with some "well behaved" but remediable monopolies and may try to remedy "bad" but unavoidable monopolies.

## 2. Predatoriness as Unlawful Conduct

The original Turner-Areeda definition of predatory pricing addressed the (relatively) narrowly-defined case in which the plaintiff, seeking primarily damages, challenges the specific pricing conduct of a monopolist. The plaintiff must establish, first, that the defendant has sufficient market power to render it a firm with monopoly position and, second, that it has "abused" its monopoly position by charging predatorily low prices. Given proof of both elements, the plaintiff is entitled to damages and injunctive relief as to pricing. This plaintiff does not seek any dissipation of the defendant's monopoly position; it merely demands that defendant's use of its monopoly power be regulated so that plaintiff's economic interests are not harmed. Indeed, plaintiffs in such cases may affirmatively desire the ultimate umbrella of monopoly prices. The unarticulated premise here is that the monopolist has a *duty* to charge a monopoly price.

The policy underlying Turner and Areeda's restrictive definition of a predatory pricing is clear. In a competitive market, in long-run equilibrium, prices would never exceed average total cost. Any firm unable to keep its costs at or below the industry average would be reasonably certain to fail. If the plaintiff cannot survive when the monopolist charges an *above-cost* price, it could not have existed in a competitive market and can only exist because the monopolist holds its price high enough. The plaintiff is a "victim" of a price reduction by such a monopolist only because its prior expectations of the monopoly-price umbrella are disappointed.<sup>32</sup> Al-

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terrence is by a large fine, levied once. See K. ELZINGA & W. BREIT, *THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS* (1976).

32 A similar analysis seems to underlie the Second Circuit's rejection of Berkey Photo's demands that Eastman Kodak share technological information about its new products. 603 F.2d 263, 279-85. Berkey wanted to share in the Kodak monopoly rather than face a competitive market. Such a limited claim may well confront courts with very significant risks of undesirable consequences if they give a "false positive" answer to the claim of predation. To avoid such risks, it may be rational, if such claims are to be accepted at all, to define rigorously the conduct required. For analysis of the false positive and false negative risks, see Jaskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979).

lowing such a victim to force its monopolist competitor to raise prices or pay damages serves no social or economic public interest.

In both unlawful structural monopoly and abuse of monopoly position cases, the plaintiff must first prove the monopolistic position of the defendant—only then does the court consider the defendant's conduct. But the focus here is quite different, suggesting distinct meaning to the characterization of such conduct as "predatory." In an abuse of monopoly case, a conclusion of predation means that the court should provide damages and/or injunctive relief to abate the abusive conduct; whereas in a case challenging the monopoly power as unlawful, the predation characterization means that the market power is itself wrongful and should be remedied. The latter conclusion does not demand or even suggest that the conduct which made the continued possession of power wrongful should itself be the basis for damages or specific injunctive relief.<sup>33</sup> The only damage claims which can in fact be valid will involve overcharges, even though such prices are neither predatory nor exclusionary.<sup>34</sup>

33 Cf. *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295, 344-45 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954). Of course, in that case, once the monopoly was declared unlawful, victims of its purported overcharges claimed damages. See, e.g., *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968).

34 See *Hanover Shoe*, 392 U.S. 481 (1968). See also P. AREEDA & D. TURNER, *supra* note 1, ¶ 710. ("Monopoly pricing and monopoly profits should not be deemed either an 'exclusionary' act or an 'abuse' of monopoly power under § 2.")

Illustrative of the frequent confusion of these two uses of conduct are the opinions of the Federal Trade Commission (FTC) in the *ReaLemon* case. In *re Borden, Inc.*, 92 F.T.C. 669 (1978), *aff'd*, 674 F.2d 498 (6th Cir. 1982), *vacated*, 461 U.S. 940 (1983), *modified decree entered*, 102 F.T.C. 1147 (1983). Chairman Pertschuk, writing for the majority, first found *ReaLemon* to be a monopolist in the reconstituted lemon juice market and then relied on its conscious, selective, and deep price cutting (aimed at its strongest competitor which was apparently also a lower cost producer) as evidence that *ReaLemon* was consciously trying to maintain a monopoly position. 92 F.T.C. at 795-802. This conduct sufficed to make *Borden's ReaLemon* an unlawful monopoly, and the issue then became one of remedy: Specifically, what remedy would most easily dissipate this unlawful monopoly? *Id.* at 806-09. Although the original complaint proposed compelling the licensing of *Borden's ReaLemon* trademark, *id.* at 774-76, a remedy which would have gone to the core of the monopoly power, that proposal unleashed a pack of negative responses. See, e.g., amicus briefs filed in the proceeding, 310 PAT. TRADEMARK & COPYRIGHT J. (BNA) D-1 (amicus brief of the U.S. Trademark Association) (January 6, 1977); 321 PAT. TRADEMARK & COPYRIGHT J. (BNA) E-1 (amicus brief of the U.S. Dept. of Commerce) (March 24, 1977). See also Pallandino, *Compulsory Licensing of a Trademark*, 26 BUFFALO L. REV. 457 (1977); Note, *Compulsory Trademark Licensure as a Remedy for Monopolization*, 26 CATH. U.L. REV. 589 (1977). Consequently, the Commission majority opted over Chairman Pertschuk's partial dissent to focus its remedy strictly on *Borden's* pricing conduct. 92 F.T.C. at 807-08, 809-13. See also 102 F.T.C. at 1147-50. Importantly, the majority opinion did so on the theory that this would dissipate the monopoly power itself. 92 F.T.C. at 807-08.

Commissioners Clanton and Pitofsky wrote separate concurring opinions in which they debated the merits of certain definitions of predatory pricing. These opinions imply that if *Borden* were able to eliminate an equally or more efficient rival by a pricing strategy that did not involve quite such deep price cuts, then *Borden's* consciously maintained monopoly

In the great run of cases in which predation is at issue, the market position of the putative wrongdoer is either not monopolistic or unknown. These cases therefore cannot involve condemnation of conduct made unlawful due to the monopoly market position of the defendant. These cases involve challenges to conduct the lawfulness of which does in some cases take account of the defendant's market position, but in other cases, there is no connection to market position. This dual treatment is strange because generally courts want proof of a likelihood of success (potentiality for monopoly), coupled with clearly wrongful conduct, before they will find a violation.<sup>35</sup> But in predatory price cases many courts have not insisted on that link.<sup>36</sup> The policy behind making one type of price conduct illegal under section 2 without regard to the likelihood of success or general effect on the market is at first blush puzzling. Indeed, if courts were asked to explain the connection between such "predation" and the traditional concerns of monopoly and attempt to monopolize law, one suspects they might have some difficulty.

One can rationalize the connection.<sup>37</sup> For example, if predatory prices are always unambiguously evil or unjustified by any legitimate market or competitive objectives, then it is reasonable to fashion an across-the-board condemnation. Such prices are impermissible and irrelevant weapons for lawful competition. Such conduct could only reduce competition and move a market toward monopoly. Regardless of the power of the actor or the chance of success, such conduct would be objectionable as without any possible redeeming feature. This is a slightly expansive definition of the attempt concept, but it has a sound basis in both logic and policy.

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position would not have been unlawful. *Id.* at 822-24 (Pitofsky, C., concurring); *id.* at 814-16 (Clanton, C., concurring). It is impossible to say whether either author in fact subscribed to such a theory because neither discussed the legal function of characterizing the pricing conduct in that case. Intent on joining the debate about the definition of predatory price, the opinions subtly transformed the general understanding of the *ReaLemon* case and suggested that the only issue before the FTC was the unlawfulness of specific conduct by an otherwise not unlawful monopolist. Many of the responses to the original Areeda and Turner article suggest a similar confusion as to the legal meaning of a predation conclusion. See, e.g., Scherer, *supra* note 2, at 869.

Despite confusion on the issue of lawfulness of conduct versus monopoly power, the entire case focused on a firm which was clearly a monopoly. Thus, even as a conduct case, the issue was the validity of specific conduct by a firm with such power.

35 See, e.g., *United States v. American Airlines, Inc.*, 743 F.2d 1114 (5th Cir. 1984), *cert. dismissed*, 106 S. Ct. 420 (1985); *United States v. Empire Gas Co.*, 537 F.2d 296 (8th Cir. 1976), *cert. denied*, 429 U.S. 1122 (1977). Cf. Cooper, *Attempts and Monopolization: A Mildly Expansionary Answer to the Prophylactic Riddle of Section Two*, 72 MICH. L. REV. 373 (1974).

36 See, e.g., *Adjusters Replace-A-Car, Inc. v. Agency Rent-A-Car, Inc.*, 735 F.2d 884 (5th Cir. 1984), *cert. denied*, 105 S. Ct. 910 (1985).

37 *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014, 1027-31 (9th Cir. 1981), *cert. denied*, 459 U.S. 825 (1982).

It is also consistent with a long-standing strand of attempt analysis.<sup>38</sup>

The justification for such an expansive inclusion of pricing conduct within the attempt category would also explain why it is then rational to impose a very restrictive standard in defining the pricing behavior which violates section 2. That low prices relative to costs can be a vital element in effective competition is intuitively obvious. Such prices can introduce new products by capturing customer attention; they can result from oversupply or a sudden decline in demand; and they can also result from higher than expected production costs.<sup>39</sup>

Not only, then, may relatively low prices be rational; but if the definition of what constitutes a predatory price is vague, a high-cost, inefficient competitor can make anticompetitive, strategic use of a predation charge. Hence, in defining predatory prices for such a sweeping attempt concept, the focus should be on a clear definition of those prices which are unambiguously without justification in a competitive market. Such an approach retains a clear basis in monopoly law and its policy concerns. It seeks to eliminate conduct which is not merely unfair in some ethical sense but also likely, whether intended or not, to cause harm to the competitive process and to hasten the arrival of monopoly.

The result, as mirrored in a number of cases,<sup>40</sup> is not as definitive as the policy rationale would seem to demand. Courts consider price-cost relationships, but also evaluate intent and legitimate explanations for pricing behavior. Most such cases do draw a clear line of demarcation: A fully compensatory price, i.e., one which covers all costs, whatever its effect on other competitors, is lawful. The problems of excuse and justification only arise for prices which are below the long-run measure of economic survival and therefore demand some further justification. In a competitive market, such prices can and predictably would occur; hence, they cannot in and of themselves be wrongful—even if they contribute to the growth of

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38 See *Lessig v. Tidewater Oil Co.*, 327 F.2d 459 (9th Cir.), *cert. denied*, 377 U.S. 993 (1964).

39 In an effectively competitive market, producers confronting high costs, if they wish to remain in the market, must still sell at the market price. While in classic economic theory no firm will remain in such a market when its marginal costs exceed its expected prices, in the real world such conduct is not always irrational. For example, a new entrant confronting initial learning costs may predict lower cost in the future but only if it continues to produce. Alternatively, given high exit and restarting costs, a firm expecting better prices in the future may continue to operate despite short term loss.

40 See, e.g., *Transamerica Computer Co. v. IBM Corp.*, 698 F.2d 1377 (9th Cir.), *cert. denied*, 464 U.S. 955 (1983); *MCI Communications Corp. v. AT&T Co.*, 708 F.2d 1081 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983); *Janich Bros., Inc. v. American Distilling Co.*, 570 F.2d 848 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978); *O. Hommel Co. v. Ferro Corp.*, 659 F.2d 340 (3d Cir. 1981), *cert. denied*, 455 U.S. 1017 (1982).

market position of the firm employing them. Other factors can make the analysis even more complex.<sup>41</sup>

There is another possible explanation for the concern about predatory prices divorced from any present danger of monopoly. The common law of unfair competition has always recognized that some kinds of price competition might be unlawful. The common law, however, lacked a workable definition of what prices were unfair.<sup>42</sup> Nevertheless, English common law embraced a standard which made lawful any price made in good faith to compete, even if the firm intended to drive another from the market.<sup>43</sup> Low prices were unlawful only if set with "malice," which entailed a nonmarket-oriented desire to inflict harm on another.<sup>44</sup> The first Restatement of Torts and the few American courts which have decided similar cases seem to have adopted this point of view.<sup>45</sup> The key to creating a more restrictive standard lay in finding some criteria to judge the merits of prices themselves.

A second problem for the development of a common law of unfair low pricing in the United States is the nation's federalist structure in which more than fifty independent jurisdictions define

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41 In the recent titanium-dioxide case, the FTC evaluated the pricing conduct of a dominant firm having clear cost advantages over its rivals. *In re E. I. DuPont de Nemours & Co.*, 96 F.T.C. 705 (1980). The dominant firm employed limit pricing and strategic expansion in a confessed effort to discourage new entry and acquire all growth in demand. *Id.* at 707. The resulting prices were above total cost and quite consistent with or even above those which a competitive market would have produced. In addition, the planned plant expansions reflected rational business decisions regardless of any expected monopoly profit. The Commission unanimously rejected its staff's challenge to this conduct. It did so, however, only after an extended analysis of the evidence of the legitimacy and rationality of the conduct at issue. The Commission apparently felt obliged by the defendant's position as a dominant firm to make such a review and to test rigorously the conduct's rationality as business behavior in a competitive market and was not satisfied to merely compare it with abstract pricing formulae. *Id.* at 721.

42 The famous English case of *Mogul Steamship Co. v. McGregor, Gow, & Co.*, 23 Q.B. Div. 598 (1889), *aff'd*, 1892 A.C. 25, illustrates the problem and its traditional resolution. A group of steamship lines had colluded to exclude a competitor by several tactics including price cuts to levels well below total cost. The court focused on the lawfulness of the prices. (A comparable American case reached an opposite result because of its focus on the conspiracy issue and the clear American law outlawing such conspiracies. See *Thomsen v. Cayser*, 243 U.S. 66 (1917)). In *Mogul Steamship*, one judge argued that any price below average total cost was unlawful if it diverted trade. 23 Q.B. Div. at 609-11 (Lord Escher). The majority rejected this approach because it would constrain too much and too ambiguously the freedom of action of competitors. *Id.* at 613-15 (Bowen, J.); *id.* at 625-28 (Fry, J.). In the majority's view, below-cost prices made legitimate economic and business sense in a number of market contexts. Nevertheless, because low prices could destroy the business of another, even the majority believed that such prices should be subject to some legal review. *Id.* at 615, 625.

43 *Id.* at 613-15 (Bowen, J.).

44 *Id.* at 615, 625.

45 *Kapper v. Katz*, 7 Cal. App. 2d 1, 44 P.2d 1060 (1935); *Dunchee v. Standard Oil Co.*, 152 Iowa 618, 132 N.W. 371 (1910); *Tuttle v. Buck*, 107 Minn. 145, 119 N.W. 946 (1909); RESTATEMENT OF TORTS § 708 (1938). *Cf.* *Thomsen v. Cayser*, 243 U.S. 66 (1917).

the common law system. This system makes both progress and resolution of conflicts very difficult and subjects most major economic actors to multiple and potentially conflicting rules. Thus, the Sherman Act's adoption was partly motivated by a desire to "federalize" the common law on restraint of trade and monopoly.<sup>46</sup>

Narrowly defined, these antitrust categories probably did not include the general topic of unfair competition. However, courts have frequently defined the Sherman Act's concerns broadly and used it as a device to establish a federal jurisdiction over, and relatively uniform standards for, any and all anticompetitive conduct which affects interstate commerce.

In this context, Turner and Areeda's effort to define predatory pricing both gave content to the ambiguous common law tort of unfair prices and helped to provide it with a federal forum. This is not to suggest that Professors Turner and Areeda had such an expansive agenda. Their article in fact carefully limited the cases for which they were defining predation to conceded but otherwise lawful monopolists. Nonetheless, their analysis provided economic criteria for judging the fairness of price regardless of economic structure. Thus, courts could and did apply their definition of predation to all cases in which the issue was the "fairness" of a pricing strategy.

In defining predation in cases involving nonmonopolists, courts ought to be at least as conservative, i.e., restrictive, as they would be in attempt to monopolize cases. Predation by nonmonopolists poses no necessary threat to competition or the overall competitiveness of markets. At most predatory pricing here represents an impermissible harm to another competitor. Any judicial review of such pricing creates significant risks of false positive findings which would condemn conduct which is in fact both economically and socially desirable. Hence, absent monopoly, near monopoly, or at least a threat of monopoly, the risks of judicial review suggest that only very clearly wrongful pricing ought to be condemned.<sup>47</sup>

In sum, there are three relatively distinguishable variations on the basic theory that certain low prices are themselves wrongs. The degree of monopoly may be relevant to the choice of a suitable definition of what is too low a price; thus, many circuits do in fact have

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46 H. THORELLI, *supra* note 7, at 181-84; W. LETWIN, *supra* note 7, at 96.

47 There are a number of important policy issues which courts should consider when they evaluate a sweeping assertion of predation jurisdiction. For example, why give treble damages for this business tort but not for others, even others which have direct federal law status? See, e.g., Lanham Act § 43a, 60 Stat. 427, 441 (1946) (codified at 15 U.S.C. § 1125(a) (1982) (predatory, false, comparative advertising declared illegal and private remedies created). See generally Bauer, *A Federal Law of Unfair Competition: What Should Be the Reach of Section 43(a) of the Lanham Act?*, 31 UCLA L. REV. 671 (1984).

somewhat varied standards.<sup>48</sup> None of these approaches makes the market power of the defendant illegal in itself.

### 3. Unlawful Monopoly Engaged in Unlawful Conduct

The final legal context in which the predation issue may arise involves a combination of the first and second theories. Here, the plaintiff first establishes that the defendant possesses an unlawful monopoly.<sup>49</sup> Second, the plaintiff demands only damages resulting from the unlawful monopolist's pricing conduct and/or an injunction against that conduct. What is not sought is a remedy that would redress the unlawful monopoly power itself.

There is an obvious anomaly in this approach. Having established the illegality of the defendant's monopoly position, what right has the plaintiff to demand that a court ignore that continuing offense so long as the defendant pays the plaintiff tribute, in the form of treble damages, and makes some specific reformation of its conduct which will protect the plaintiff? Unfortunately, the courts themselves seem to insist upon this anomaly. They have expressly refused or shown deep reluctance to grant private litigants relief aimed at exterminating unlawful monopoly power.<sup>50</sup> Given such judicial responses, the private plaintiff is left with damages and, perhaps, a narrowly drawn, conduct-oriented injunction.

However, if unlawfulness requires not only willful acquisition and maintenance of monopoly power, but also demonstrable remediability, then it is probable that most private cases do not satisfy that last criterion. Hence, it is not accurate to describe those monopolies as unlawful. The case proven is in fact solely one of the second type: an unlawful abuse of a monopoly position. But courts often first find the monopoly itself unlawful, as a step in the damage analysis, without explanation of the relevance of the conclusion.<sup>51</sup>

Unfortunately, such a finding suggests that any strategic pricing which is evidence of unlawful monopolization is also a basis for damages. There is no need, however, to link those conclusions. Conduct which makes monopoly power unlawful need not inevitably provide a basis for damages. Similarly, no economic logic dic-

48 See, e.g., *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985); *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014 (9th Cir. 1981), *cert. denied*, 459 U.S. 825 (1982); *International Air Indus. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976).

49 Cf. *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 272-73 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980).

50 *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985); *IT&T Corp. v. GTE Corp.*, 518 F.2d 913, 920-24 (9th Cir. 1975). Cf. *Berkey Photo*, 603 F.2d at 296 n.55.

51 See *Berkey Photo*, 603 F.2d at 272-73.

tates that those prices which would be unlawful in an attempted monopoly case (or even an abuse of a not unlawful monopoly position case) would alone qualify for damages given an unlawful monopoly.<sup>52</sup> This in turn suggests that courts should more carefully delimit the focus of a plaintiff's case.<sup>53</sup>

One might therefore suggest that, in a damage case or one demanding specific conduct remedies, the only relevant issues are whether the defendant is a monopolist or otherwise governed by section 2, and whether the specified conduct is wrongful. The lawfulness of the monopoly power itself is not an issue. The latter is still relevant, but only if the plaintiff is seeking (and is entitled to seek<sup>54</sup>) a remedy aimed at termination of the unlawful power.<sup>55</sup> Of course, one should also confront the question of the damage rights of customers or suppliers who were victims of the exploitative prices of such an unlawful monopoly.<sup>56</sup>

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52 One arguable position is that, if the monopoly is itself unlawful, any price below average total cost would justify damages while, if there is no monopoly or no unlawful monopoly existed, only prices below variable cost could be the basis of a damage claim. To avoid obvious circularity, it would be necessary to define unlawful monopoly not only in terms of conduct but also in terms of remediability so that the more generous damage award standard would directly encourage pricing conduct favorable to efficient entry into markets where competition has been proven to be a practical alternative.

53 See, e.g., *Berkey Photo*, 603 F.2d 263.

54 Based on the sweeping statutory language of the Clayton Act one would have thought such an entitlement was clear. See Clayton Act § 16, chap. 323, 38 Stat. 730, 737 (1914) (codified at 15 U.S.C. § 26 (1982)) ("Any person . . . shall be entitled to . . . injunctive relief . . . against threatened . . . violation of the antitrust laws . . ."). Although key opinions seem to reject a right to structural relief, see note 50 *supra*, this does not negate other conduct-oriented remedies which have as their objective not regulating the use of monopoly power but rather its extermination. See *United States v. American Can Co.*, 126 F. Supp. 811 (N.D. Cal. 1954) (lease terms forbidden and defendant ordered to sell its equipment at favorable prices); *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295, 346-47 (D. Mass. 1952) (lease-only contracts forbidden in order to create gradual restructuring of the market).

55 One can also argue for a different damage right when the monopoly is unlawful in the type-one analysis sense. See text accompanying notes 24-31 *supra*. If the plaintiff has shown the defendant's monopoly to be remediable, the resulting unlawfulness of the defendant's power justifies a more generous measure of damages. Any conduct not "impelled" by economic circumstances would justify damages including all strategic pricing profits, whether above or below cost, which in any way aids the monopolist in retaining its position. In addition, the measure of damages could be the difference between the optimal short-run monopoly price and any prices actually charged. Such a damage rule would tend to force an unlawful monopolist to keep its prices at a high level. That in turn would expedite entry. One might, of course, argue that such an approach is inefficient. *Ex hypothesi*, the monopoly to be unlawful must be remediable, and therefore a direct remedy would probably speed the restructuring of the market and involve lower economic costs. But this result demands that the courts grant such remedies whenever unlawful monopoly is proven.

56 See note 34 *supra*.



#### 4. Conclusion

While courts and commentators believe that labeling a price as predatory is fraught with legal significance, and to date they have put great emphasis on defining what is "predatory," there has been little reflection on the legal relevance of the conclusion. When we ask about legal relevance, it appears that the reasons for assessing the merits of a pricing strategy may well vary depending upon whether the claim is that the monopoly is itself illegal, that an actual but not unlawful monopolist has abused its position, that a nonmonopolist is attempting to monopolize a market by offering low prices, or, finally, that a firm has engaged in unfair competition by utilizing low prices which harm a competitor.

What is unlawful should depend upon *why* that information is relevant to the claim before the court. No basis exists for thinking that there is, or necessarily should be, a single definition of what is an unlawfully low price. Nevertheless, courts and commentators seem far more interested in debating the abstractions of economic theory than in evaluating the legal relevance of price conduct to the particular type of monopoly case presented.

#### B. *Application of Economic Theories of Predation to the Litigation Context*

If courts are going to practice economics, they better do so correctly and with some understanding of what they are doing. In the context of antitrust law, economic theory can be a tool of factual analysis or it can be a type of formalistic, doctrinal constraint on relevant factual inquiry.

As a tool, economic theory makes predictions about consequences that will result from conduct under given, i.e., assumed, conditions. It can also suggest what consequences might have resulted if different conduct had occurred or if the assumed conditions were varied. Finally, economic theory suggests values and goals for antitrust policy. If efficient, dynamic markets are a primary objective, then economic theory can begin to set some criteria to test for their existence.

When economic theory is deployed as a tool of analysis, it has to fit the facts. Turner and Areeda, for example, expressly assumed market conditions for the price-setting firm which meant that the firm in selecting its prices would have no significant concern for its long-run market dominating position.<sup>57</sup> This monopoly was, for some unstated reason, invulnerable to competition. Professors Scherer, Williamson, and others have expressly or implicitly varied

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57 Areeda & Turner, *supra* note 9.

those assumptions.<sup>58</sup> In particular, they have not assumed any long-run invulnerability for the monopolist. Consequently, they have argued that prices which do not violate the Turner-Areeda guidelines could still exclude socially desirable competitors and that such prices thus should be unlawful.<sup>59</sup> The resulting debate often turned on points of model building and general applicability rather than on any factual validity, set in specific contexts, of the alternative assumptions.

If economic analysis is to be used as an instrument to help inform and illuminate legal policy, such analysis of specific cases is vital. But such an instrumental use of economic theory also requires precise definition of the legal issues being resolved and a clear statement of why predation is legally relevant to any case. Thus, until the economic theorist has a legal standard to evaluate, there is no basis on which to define the term "predatory price."

It should matter greatly to the economic analyst whether the legal issue being considered is one of the lawfulness of the monopoly itself, i.e., should the courts do something to dissipate the monopoly, or whether the issue is the tortious quality of specific pricing conduct under one of the three legal analyses developed earlier.<sup>60</sup> Of course, an economist might conclude that the same definition of predation ought to apply in all circumstances, but this conclusion requires a consideration of competing economic values and policies as they relate to each type of claim. Such a focus, at least initially, is far removed from the specifics of defining predatory price.

It is not my purpose here to discuss the validity of differing approaches to defining predation (from either a functional or doctrinal perspective). That has been done well elsewhere.<sup>61</sup> I wish only to emphasize that any economic analysis of predation must depend on the legal issue to which the analysis relates. Yet, most of

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58 Banmol, *Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing*, 89 YALE L.J. 1 (1979); Scherer, *supra* note 2, at 869-83; Williamson, *supra* note 2, at 286-306. See also Brodley & Hay, *supra* note 2, at 751-56.

59 The *ReaLemon* case provides a concrete example wherein this seems to be true. *In re Borden, Inc.*, 92 F.T.C. 669, 826-31 (1978) (Pitofsky, C., concurring), *aff'd*, 674 F.2d 498 (6th Cir. 1982), *vacated*, 461 U.S. 940 (1983), *modified decree entered*, 102 F.T.C. 1147 (1983). Specific case studies have supported this view. See D. Rosenbaum, *A Study of Firm Strategies Designed to Deter Entry as Revealed in Three Antitrust Cases* (Ph.D. dissertation, Univ. Wisc. 1985) (reviewing facts of *ReaLemon* (discussed in note 34 *supra*), *In re E. I. DuPont de Nemours & Co.* (the titanium-dioxide case, discussed in note 41 *supra*), and *Aluminum Co. of Am.* (see notes 8 and 27 *supra*), and demonstrating conditions under which equally efficient producers could be eliminated). Cf. R. POSNER, *supra* note 2, at 191-93.

60 See text accompanying notes 15-56 *supra*.

61 See Brodley & Hay, *supra* note 2, at 757-64; Jaskow & Klevorick, *supra* note 32, at 219-22; Schmalensee, *On the Use of Economic Models in Antitrust: The ReaLemon Case*, 127 U. PA. L. REV. 994 (1979); Zerbe & Cooper, *supra* note 2, at 659-77.

the economists and lawyers writing on the topic of predation have failed to define that issue, and so their work can be of only marginal relevance to any legal analysis of the conduct at issue in the cases.

The other use of economic theory is as a type of formalistic, legal doctrine. In specific cases, courts need not know why predation is bad; if the defendant's conduct violates a rule laid down by an authority, liability exists. Such economic doctrines may have rational bases in theory and be quite relevant as an empirical explanation of conduct under assumed conditions. In fact, courts originally may have embraced such theories as good explanations for specific factual situations. However, once courts accept that theory establishes the criteria for a violation rather than that theory provides a way to evaluate facts, economic theory takes on a doctrinal function. It specifies the factual conclusions that must exist before a violation can occur. Such an approach puts an even greater premium on the correct use of the economic tools. Slight factual distinctions become outcome determinative.<sup>62</sup>

Another key problem in any application of economics to litigation is that the cost concepts of economics have no necessary counterparts in business accounting.<sup>63</sup> This is particularly true of the variable-cost concept. Turner and Areeda's formulation has become increasingly arbitrary regarding what costs to include in com-

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62 Whichever use a court makes of economic analysis, it must use it correctly. While it is true that predatory price itself is not an economic concept, it can be, and always is, defined by reference to established economic terms. Most traditional economic concepts have relatively clearly-defined theoretical meanings. The key economic concepts are "average total cost" and "marginal cost." The second is approximated by "average variable cost." Such cost concepts have a number of components, including "time."

The time period is an especially crucial factor in variable-cost analysis. The shorter the period, the more factors and consequent costs are fixed. If we look at each day as a separate period, we may see unused capacity, *e.g.*, an unfilled bread loaf pan and an empty place in a bread truck. The incremental cost of a loaf is then but the cost of ingredients. This eliminates almost all production cost and suggests the average variable cost is very low. Breadmaking emerges with very high fixed costs; but if one takes a longer period of time, a week, a month, or even a year, more and more of the costs become controllable and so variable.

Moreover, economic analysis does not always focus only on the short run. In the case of new entry, the rational entrant must expect total income to equal or exceed total costs. Hence, if a court discovers that a firm is both entering a market *and* charging prices below its average total cost, such a firm is, *prima facie*, acting irrationally. Yet future expected above cost prices could explain that behavior. Hence, it is relevant to inquire under what conditions could such an entrant expect or obtain its long-run profit. Manifestly, if over a reasonable time period, the entrant can expect to recover all its costs and earn a reasonable return on its investment, its entry decision is rational. Of course, its future profit could result from excluding its existing competitors and charging a monopoly price, or from its costs falling as it gained experience, or from demand expanding in response to its lower prices, yielding a volume at which lower costs would make its prices profitable. A court might therefore evaluate the merits of such conduct differently even though the cost data is similar.

63 See Areeda & Turner, *supra* note 9, at 716-18.

puting the concept of average variable cost.<sup>64</sup>

Equally challenging problems arise when courts try to determine appropriate average total costs. To an accountant, costs are expenses and so total costs involve all expenditures which an enterprise must make; but there is no price, and thus no cost, for using any capital invested in the enterprise as ordinary equity. Hence, to the accountant, when the firm recovers its expenses (including overhead and other fixed costs), it is operating above total cost even if its common stock owners receive nothing. In contrast, the economic definition of total cost includes all costs required to keep the enterprise in the business, and so, total cost includes a reasonable return on equity as an essential part of the costs of doing business.<sup>65</sup>

Finally, consider the fact that classic economic price theory is static. It describes a world in equilibrium. The world may be monopolistic or competitive, but the economic model only predicts what prices firms will charge in order to maximize profits (on the assumption that their conduct will not affect the future condition of the market). Some economists question whether such a static view of conduct has any relevance to antitrust concerns with the dynamics of conduct by which firms acquire and maintain market positions.<sup>66</sup> Thus, a court confronts a three-fold problem of deciding whether a static price theory is appropriate, how exactly to define the time period and other elements of the theory chosen, and how to relate accounting data to the economic theory.

A number of cases illustrate the failures of judicial legal-economic analysis of predation. Two recent decisions, *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*<sup>67</sup> and *Adjusters Replace-A-Car, Inc.*

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64 See *In re Borden, Inc.*, 92 F.T.C. 669, 815 nn.5 & 6 (1978) (Commissioner Clanton discussing changes in definitions of Turner and Areeda), *aff'd*, 674 F.2d 498 (6th Cir. 1982), *vacated*, 461 U.S. 940 (1983), *modified decree entered*, 102 F.T.C. 1147 (1983).

65 See, e.g., *Areeda & Turner*, *supra* note 9, at 704. The following example reveals the difference: Suppose a business employed \$1 million in capital and, after all costs and traditional expenses were paid, had a profit of \$1,000. That would mean that it had earned a return of .1% on its investment. To the accountant, this firm had priced above costs. On the other hand, since the return would be manifestly inadequate to justify continued investment in the business, the economist would say that this firm had priced below its average total cost. Failure to appreciate the difference in these views of total cost is very troublesome especially if, as many courts have held, prices above average total cost are irrebuttably presumed to be lawful. See *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985).

66 Demsetz, *Two Systems of Belief about Monopoly*, in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* 166 (H. Goldschmid, H. Mann & J. Weston eds. 1974); Gaskins, *Dynamic Limit Pricing: Optimal Pricing Under Threat of Entry*, 3 J. ECON. THEORY 306 (1971); Williamson, *supra* note 2, at 284-86. See Carstensen, *Vertical Restraints and the Schwinn Doctrine: Rules for the Creation and Dissipation of Economic Power*, 26 CASE W. RES. L. REV. 771 (1976).

67 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985). See text accompanying notes 69-113 *infra*.

*v. Agency Rent-A-Car, Inc.*,<sup>68</sup> provide vivid examples of the difficulties that arise for those courts that use an uninformed labeling of conduct.

### III. Pricing Strategy as Part of a Program of Monopolization: The Asphalt Paving Case

#### A. *The Johnson Case*

By the late 1960s, the S. E. Johnson Company (Johnson) was the leading asphalt paving contractor in Northwestern Ohio, but it was not a monopolist.<sup>69</sup> Johnson confronted a number of active competitors in bidding for a specialized class of contracts for state highway and turnpike work. Johnson also had integrated backward, producing the stone for asphalt which is its bulkiest and most costly component<sup>70</sup> and acquiring paving-related businesses such as a bridge construction company.<sup>71</sup>

In the late 1960s and early 1970s, all paving companies recognized that the amount of paving work from public sources was going to decline substantially.<sup>72</sup> Faced with this shrinking market, Johnson commenced a program to expand its dominance of the paving business. It acquired pavers, asphalt producers, and stone quarries, and also adopted a bidding policy for state and turnpike projects that kept its bids very low.<sup>73</sup> Although Johnson apparently never bid below its out-of-pocket costs, its bidding strategy made it economically unfeasible for other pavers to remain in the business.<sup>74</sup> Many of these firms sold out to,<sup>75</sup> and their owners entered into covenants not to compete with,<sup>76</sup> Johnson.

Johnson contended that it was more efficient than its competitors and so could charge low but barely profitable prices which its competitors could not meet and remain in business.<sup>77</sup> Langenderfer, a plaintiff, contended that it was equally efficient but that Johnson's low prices either were below cost or represented a price squeeze involving price discrimination against the unintegrated firms.<sup>78</sup>

68 735 F.2d 884 (5th Cir. 1984), *cert. denied*, 105 S. Ct. 910 (1985). See text accompanying notes 114-51 *infra*.

69 729 F.2d at 1053.

70 *Id.*

71 *Id.*

72 *Id.* at 1052 n.3.

73 *Id.* at 1054-58.

74 *Id.* at 1055.

75 *Id.* at 1053-54.

76 *Id.* at 1053-54. See also Brief for Appellees at 13, *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985).

77 729 F.2d at 1055-56.

78 Brief for Appellees, *supra* note 76, at 43-44.

Thus, the plaintiffs' experts characterized the Johnson bidding practices as "predatory"<sup>79</sup> as well as involving a "profit squeeze."<sup>80</sup> Johnson, treating the claim as one of "predatory pricing," argued that its pricing was not wrongful since it was above an accounting version of total cost.<sup>81</sup> The plaintiff also stressed that Johnson's acquisitions, both vertical and horizontal, were key factors in altering the market. Since the plaintiffs cast this largely as a Clayton Act claim and did not integrate it with the pricing strategy, Johnson contended that the acquisitions were intrastate and therefore outside the Clayton Act's jurisdiction.<sup>82</sup>

The jury found that Johnson had violated the Sherman and Clayton Acts and assessed damages of almost \$1 million (before trebling).<sup>83</sup> In addition, the trial judge awarded injunctive relief. The injunction focused on the conduct of Johnson, but seemed aimed at eliminating its monopoly power as such and not merely regulating the abusive conduct of an unchallengable (lawful) monopoly. The judge refused any structural relief.<sup>84</sup>

Both sides took appeals. Johnson conceded, on appeal, its monopoly position but claimed that because its prices were above "total cost," they were lawful. It also argued that the Clayton Act did not apply to its mergers because they were intrastate. Langenderfer's argument emphasized the strong evidence of Johnson's intent to monopolize the market and the conclusions of its experts that Johnson's methods were anticompetitive. It also asked reversal of the refusal of structural relief so that a competitive structure could be established in the market.

The circuit court majority held that since Johnson's prices were above "total cost," they were per se lawful. It also held that a private plaintiff had no standing to seek divestiture under the Clayton Act's antimerger provisions, but it held that Johnson had unlawfully monopolized the market and remanded for a new trial to determine whether any "unlawful methods" had caused the plaintiffs damages.

This decision reflects a number of problems with present judi-

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79 *Id.* at 18-21, 26-28, 40-50.

80 *Id.* at 24-26, 37-39. Johnson was one of only two stone suppliers in the market. Those two firms followed consciously parallel and noncompetitive prices. *Id.* at 18, 25-26, 38. If Johnson shaded its intra-enterprise transfer price, essentially an accounting entry, its books would show it with above-cost prices while its competitors, who had to pay the higher "posted" price for stone, could not meet its prices. The brief for Langenderfer included some specific examples to support this claim. *See id.* at 19.

81 Brief for Appellants at 19-25, *Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 511 (1985).

82 729 F.2d at 1052.

83 *Id.* The judge declined to give the jury any instruction defining predatory pricing. *Id.* at 1055. His reasons for this are not clear.

84 *Id.* at 1059.

cial use of economic analysis, the definition of the basic elements, and the scope of a private action under section 2 of the Sherman Act. In order to explicate these problems, we need to start with an understanding of the alternative analyses of Johnson's conduct. It will then be possible to critique the Sixth Circuit's approach to the case and, finally, to discuss the implications of the decision.

### B. *Alternative Economic Analyses of Johnson's Conduct*

Two possible explanations exist for the overall pattern of Johnson's conduct. The first is that Johnson, being uniquely efficient, was able to lower both its costs and prices to gain fuller advantage of its efficiency. Its acquisitions would have no particular bearing on its resulting market position. Such a distinctly more efficient firm in a declining market context might well expect to have monopoly "thrust" upon it as it competes by holding its price down.

The alternative explanation is that Johnson employed a classic dominant-firm strategy of price cutting and acquisition to eliminate competition.<sup>85</sup> In this explanation, low prices so inform both existing competitors and potential entrants that they cannot expect to make profits in this business. Existing firms will then consider exiting, especially if their owners have other, more profitable businesses to which they can devote attention and any remaining assets of the old businesses. The dominant firm's acquisition program eliminates the remaining assets of such competitors, foreclosing access to the market.

This strategy assumes that entry by construction of new facilities is unattractive. In declining markets, investment in new facilities is indeed less likely than that existing facilities would continue to be used. If, in addition, the dominant firm enjoys a differential degree of vertical integration to a level at which oligopolistic pricing prevails, overall enterprise profitability need not be greatly at risk. It can squeeze prices of competitors at the level it wishes to dominate, forcing them to exit, buying their assets, and binding their principals to contracts not to reenter the market, without even a loss of overall profitability.

To test these explanations, one needs more than claims; one needs facts. For example, Johnson claimed it was more efficient but never explained how it achieved that status.<sup>86</sup> The plaintiffs offered

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85 See, e.g., *United States v. American Tobacco Co.*, 211 U.S. 106 (1911).

86 Brief for Appellants, *supra* note 81, at 21-27. While it is true that the majority seems to have accepted this claim, see 729 F.2d at 1056, it did so assuming that Johnson's prices were at or above average total cost and yet below the prices needed by its competitors to cover their costs. See *id.* It appears possible that the court committed economic error and, consequently, its conclusion has no rational basis of support. See text accompanying notes 90-91 *infra*. Certainly, the defendants' brief relies on an economically incorrect definition

opinion testimony to the effect that the plaintiff companies were as efficient as Johnson, but the basis for these conclusions is not spelled out in the briefs.<sup>87</sup>

Because Johnson operated several quarries and several asphalt plants, the usual economies-of-scale explanations seem unlikely. It was also more vertically integrated than its competitors. It is possible that Johnson's commonly owned corporations could achieve coordination economies not available to independent firms seeking the same coordination via contract.<sup>88</sup> The theory is appealing but is not even suggested in Johnson's brief.

The strongest case for Johnson, and the basis of the Sixth Circuit's characterization of Johnson as more efficient, was Johnson's claim that its prices were "above cost"; yet its competitors by their own admission could not meet those prices and survive.<sup>89</sup> This would be strong evidence of greater efficiency—but only if an economically correct measure of average total cost is employed.

Johnson reported that its "profit" margins averaged 5.3% of its paving revenues.<sup>90</sup> We have no data on Johnson's capital investment in paving, and so we cannot tell how such a return on sales translates into return on invested capital.

Thus, it seems very likely that the Sixth Circuit, misunderstanding the definition of average total cost, mistakenly concluded that Johnson's accounting data proved it had charged prices above average total cost. But unless Johnson's annual sales were twice its capital investment, it would have been earning less than 10% on its capital.<sup>91</sup>

Johnson's assumed efficiency, moreover, does not explain its pricing strategy. The plaintiffs' evidence established that Johnson intentionally "left money on the table," i.e., that it knew it could have bid higher and still gotten the same business.<sup>92</sup> Even if it were

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of average total cost. Brief for Appellants, *supra* note 81, at 20 (quoting *Utah Pie Co. v. Continental Baking Co.*, 386 U.S. 685, 698 (1967)).

87 Brief for Appellees, *supra* note 76, at 43-44.

88 Cf. Paley, *Rational Contracting, Transaction Cost Economics, and the Governance of HMO's*, 59 TEMP. L.Q. 927 (1986) (intraorganizational, relational contracting viewed as potentially more efficient than market contracting).

89 See Brief for Appellees, *supra* note 76, at 26-28, 40-42.

90 Brief for Appellants, *supra* note 81, at 13.

91 The accounting options of a multiactivity enterprise would exacerbate the ambiguity of its return. Overhead costs are frequently not clearly part of any particular activity and can be allocated at the discretion of the business—an option that a single line firm does not have. As a result, an accounting system for a multiactivity business can minimize overhead costs assigned to specific activities, thereby reducing costs and increasing the apparent profits of that activity. Johnson's multiple activities would have allowed such accounting practices, yet the plaintiffs did not make such a claim. Overall, Johnson earned about 10.5%, but its primary profits came from its gravel business. Brief for Appellees, *supra* note 76, at 23, 29-30.

92 729 F.2d at 1056-57. See Brief for Appellees, *supra* note 76, at 43-50.



more efficient, why would it voluntarily forego present profits? This is not a market in which today's discount creates tomorrow's loyal customer—highway departments are notoriously fickle. The discounts were, by definition, equally unnecessary to win the project and foreclose the specific sale. The only apparent economic rationale would be to signal to competitors that Johnson was prepared to bid below long-run break-even prices.<sup>93</sup> But why give that signal? Obviously, one explanation is to deter competitors from competing and hasten their exit from the market. In fact, no other rational, self-interested motivation would seem to exist.

In this posture, the evidence overwhelmingly suggests that Johnson was consciously following an exclusionary strategy—a strategy which relied on prices below average total cost, as an economist would define that concept, to force acquisitions and exits. Given its substantially deeper pocket and its very profitable stone business (whose prices and profits were unaffected by the paving price competition<sup>94</sup>), Johnson was uniquely able to squeeze out its less integrated but equally efficient competitors by utilizing prices which made long-run participation in the paving business unattractive. Moreover, given an uncertain and declining demand, new entry was unlikely.

For exclusionary conduct to be economically rational, the successful predator must be able to exploit its resulting dominance for some period of time. Otherwise, the cost of “predation” is unjustifiable. Some barriers to entry must exist or they must be created. Johnson's course of conduct could create at least two barriers to future competition. The first would be psychological: New entrants would face an established firm with a known willingness to cut prices deeply.<sup>95</sup> Second, potential competitors most able to enter the market, those with prior experience in the market, are precluded from entry due to the noncompetition clauses they signed.<sup>96</sup>

There is, however, a significant motivational question: Why would Johnson seek to control the least profitable form of paving, even if it could subsidize that effort with profits from its stone busi-

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93 Johnson's president implicitly offered such a characterization of its prices. Brief for Appellees, *supra* note 76, at 17-18.

94 Johnson's profits in its stone business were said to average 27% of net income and to have produced 60% to 77% of its total net income. *Id.* at 23. Johnson did not contest these figures.

95 See Gerla, *The Psychology of Predatory Pricing: Why Predatory Pricing Pays*, 39 Sw. L.J. 755 (1985). This barrier will increase as a new entrant must make an appreciable investment in capital equipment which cannot be resold except at an appreciable loss. That unrecoverable investment is then fully at risk.

96 See note 76 *supra* and accompanying text. The appellees offered no significant data supporting these agreements.

ness?<sup>97</sup> Several possibilities, not all based on rational economic calculus, exist. First, control over this class of paving might yield advantages when competing for related types of business. Elimination of competition within the paving market might reduce potential competition and its pressure on prices in related paving markets. Second, if firms with large contracts were better able to negotiate price discounts for stone, control over that paving market could reduce price pressure on the stone supply market, the very market from which Johnson received most of its profits. Finally, despite its expansion into other activities, Johnson's management may have conceived of the firm as still primarily a paver and, despite any limited potential for substantial long-run monopoly profits, may have chosen to seek and retain dominance of its traditional market.<sup>98</sup>

### C. *The Sixth Circuit's Approach*

The Sixth Circuit's majority opinion held that substantial evidence supported the claim of Johnson's monopolistic intent<sup>99</sup> and that a monopoly position had resulted from the expansion of Johnson through its horizontal acquisitions.<sup>100</sup> Moreover, because of its vertical acquisitions, Johnson was held to have made its remaining paving competitors dependent upon it as their primary stone supplier; the majority recognized stone as one of the primary costs in the paving business.<sup>101</sup>

The majority next listed twelve purported acts of monopolization which the plaintiffs had sought to prove. At this point, the majority stated, in a footnote, a test for unlawful monopolization which focuses on the lawfulness of the power itself: Plaintiffs "had to prove that Johnson *unfairly* attained or maintained monopoly power."<sup>102</sup> But in the text, the court asked whether "Johnson engaged in some type of *prohibited* anticompetitive conduct."<sup>103</sup> This later standard is a test for abuse of monopoly position or attempted monopoly.

Thus, at the outset of its conduct analysis, the majority lumped together two quite distinct analytic models. In addition, the major-

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97 The parties agreed that state highway and turnpike paving was a unique activity compared to similar work done for local government and private accounts. It also appears that the other forms of business were more profitable. Brief for Appellees, *supra* note 76, at 32 (private paving yields a higher profit than public work).

98 There was evidence that Johnson's management also acted out of personal animus toward some of its competitors. *Id.* at 17.

99 729 F.2d at 1054.

100 *Id.*

101 *Id.* at 1053.

102 *Id.* at 1055 n.7 (emphasis added).

103 *Id.* at 1055 (emphasis added).

ity later held that Johnson's acquisitions were unlawful and were a substantial factor in creating its monopoly position.<sup>104</sup> As in such classic cases as *Standard Oil*<sup>105</sup> and *American Tobacco*,<sup>106</sup> there was an unlawful program of merger to monopoly whose economic rationale was anticompetitive in the extreme.<sup>107</sup> Thus viewed, Johnson's pricing strategy, which at least eliminated all profits from its competitors' paving businesses, was an important component of its program of monopolization. Such an analysis ought to lead to the conclusion that the monopoly, if remediable, is itself unlawful. It also suggests how the pricing conduct, in the context of Johnson's existing market position, was in fact "anticompetitive" regardless of exactly how low prices were relative to some abstract, theoretical measure of cost.

Such conclusions should then have led the court to a consideration of remedy and damages. The majority instead treated Johnson's pricing conduct in isolation. This analysis assumes that the only relevant legal issue is the lawfulness of particular acts by a monopolist. Because Johnson's bids "were above the total average costs" and "Johnson continually made profits on its ventures," Johnson was entitled to a directed verdict on the issue of predatory pricing. The court characterized the plaintiffs' theory as being that Johnson had "consistently bid below the cost level of smaller competitors . . . forcing [them] . . . to choose between foregoing sales or operating at a loss."<sup>108</sup> But since Johnson had priced above its own costs, it was "more cost efficient" and had no duty to protect less efficient competitors. The court's efficiency conclusion rests on its probably erroneous application of economic definitions to the cost data. This problem has already been considered.<sup>109</sup> The next question is the legal implication of the conclusion.

The majority argued that a rule requiring a monopolist to price above its competitors' costs "would work contrary to [the goals of antitrust law] . . . by forcing a larger, more efficient firm to maintain artificially high prices to the detriment of the public."<sup>110</sup> This argument presupposes the continued existence of the monopoly and so suggests it is a lawful monopoly beyond the reach of the law. It also suggests that each act must stand in isolation. Implicitly, it asserts that the lawfulness of the monopoly position is not an issue in private litigation. Such cases can only challenge the abuse of the mo-

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104 *Id.* at 1059-60.

105 *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).

106 *United States v. American Tobacco Co.*, 221 U.S. 106 (1911).

107 See also text accompanying notes 6-14 *supra*.

108 729 F.2d at 1056.

109 See text accompanying notes 90-91 *supra*. See also note 65 *supra*.

110 729 F.2d at 1057.

monopoly position. Of course, one may well wonder whether such a restricted view of private rights does not also "work to . . . the detriment of the public." But the Sixth Circuit's opinion never addressed that question.

Despite this implicitly circumscribed analysis of the plaintiffs' rights, the majority also found that the acquisitions by which Johnson acquired its monopoly made the monopoly unlawful. Nevertheless, the opinion treated the plaintiffs' right to relief exclusively as a Clayton Act issue despite clear case law from 1904 that a program of merger to monopoly is also both a section 1 and a section 2 violation.<sup>111</sup> Consequently, the majority looked solely at the jurisdictional issue under the Clayton Act—interstate commerce—and then at a relief issue: Can a private plaintiffs in a section 7 case get divestiture? It held against the plaintiff on both issues.<sup>112</sup> Neither of these conclusions directly resolved the question of a plaintiff's right to structural relief against unlawful monopoly power.

Despite its conclusion that Johnson's pricing was lawful and that most of its mergers were beyond judicial review, the majority remanded the case for a new damage award. The majority reasoned that Johnson was an unlawful monopolist, and that the plaintiffs therefore had a right to damages so long as the award was not based on low pricing. This is a mysterious conclusion. If the monopoly was in fact unlawful, and if that fact justified a damage award, the court should have developed a comprehensive damage theory explaining when and why damages were warranted where no more directly relevant relief was allowable. If the monopoly was not itself illegal, then it is not evident what unlawful acts had occurred or caused harm to a plaintiff.

#### D. *The Implications of the Johnson Decision*

The legal theory of the *Johnson* decision is illusive. In part, the majority treats this as a case in which the key issue is the lawfulness of Johnson's monopoly position. But it is never clear why such a conclusion is relevant. As the analysis in Part II above suggests, the logical implication of such an approach is that the law should provide a remedy that will dissipate the unlawful monopoly power. The only issue that would remain is the method of eliminating the monopoly power. A court could grant an exclusively conduct-oriented decree in order to hamstring the monopolist, allowing its competitors to prosper and eventually regain their market position. Alternatively, the court could dissolve the unlawful monopoly and directly structure a more competitive market.

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111 Northern Sec. Co. v. United States, 193 U.S. 197 (1904).

112 729 F.2d at 1058-60.

The issue of damages in a case granting structural relief should be secondary because the plaintiff is already receiving a more significant remedy. The right to damages should be limited to proof that the monopolist caused losses which would not have occurred had the market remained competitive and free from monopolizing conduct. While a less efficient plaintiff would get no damages, it would still merit the injunctive relief and thereby gain a chance to "try its luck" in the field. Only a plaintiff which clearly would have survived in a competitive market could claim damages, and then only for those losses which were demonstrably the result of a difference between the hypothetical competitive condition and the actual monopolized one.

An alternative reading of the *Johnson* decision is that in a private suit the lawfulness of the monopoly is not itself at issue. In this account, the court was solely concerned with a monopolist's stewardship of its power. Such a claim still demands proof of monopoly, but the question then presented was only whether particular conduct is wrongful when engaged in by such a firm. The court's analysis could have properly focused on whether the prices charged were consistent with those which nonmonopolistic competitors might have rationally charged in the situation. In a declining market, there is good economic and business reason to predict that prices will fall below both the economist's and the accountant's definition of average total cost. But should the *Johnson* court have acquitted the monopolist of unlawful low pricing not because its prices were justified but because they were irrebuttably lawful since they were above average total cost? The court's factual conclusion was highly dubious since the information to justify it was not present.

As a result, the court misapplied its own purported standard. Moreover, one might predict that no competitor—in the absence of a monopolistic expectation—would cut prices unnecessarily (as *Johnson* did). It would bid low enough to win, but there would be no reason to give up more than that. Hence, in this context, particular pricing might be purely monopolistic even though prices were at levels which could occur for other reasons.

This raises a serious question about the price standard chosen by the *Johnson* court. Unless the court wished to encourage monopolization, it ought, perhaps, to have differentiated between cases in which conduct creates avoidable monopoly and those in which it merely alters the scope or degree of an unavoidable monopoly. Only in the latter case is it clear that substantial pricing discretion is without potential detriment to consumers in the long run.

Additionally, there are significant difficulties with such "fine-tuned" standards. They may implicitly force monopolistic prices

upward. They also make a dominant firm bear a burden of justification for a not entirely irrational price (in competitive market terms). Hence, a court could still rationally restrict damage liability for pricing to cases in which the prices were more clearly and unambiguously objectionable.

In the *Johnson* case, the plaintiffs advanced the theory that Johnson had unlawfully acquired a monopoly, which meant both that the monopoly itself was unlawful and that plaintiffs had a broad right to both damages and injunctive relief. The *Johnson* majority, on the other hand, basically asked whether a lawful, "more efficient" monopolist might charge relatively low prices, but contradicted itself by subsequently accepting plaintiffs' position that Johnson was an unlawful monopolist. The lack of focus on, let alone agreement about, the basis of the challenge to Johnson creates the fundamental confusion in the case.

Properly understood, the *Johnson* case primarily raised the question of whether or not a private party might challenge as unlawful the monopoly position of a competitor. While the case law, as well as the language of section 2, would generally seem to support such a right, there are policy reasons to restrict or forbid such claims. Private litigants act out of private interest. Assume for the moment that Johnson's combination of supply sources and plants did create a substantially more efficient production system. Should the fact that this occurred through "unlawful" merger and a calculated price strategy, whether above or below some measure of cost, allow a private party to have a court order either structural or conduct-oriented remedies? The result might be to impose significant inefficiency on the market.

There are ways to avoid the greatest risk created by these problems. First, clarifying legal theory about monopoly might help. If a plaintiff wishes to challenge the lawfulness of power itself, it should bear the burden of persuading the court that there is a monopoly, that its origins or maintenance involved anticompetitive conduct, i.e., a showing of conduct which in context lacked legitimate business justification, and that the monopoly itself similarly lacks justification as a more efficient producer in the market. This last requirement, which can also take the form of proof that a remedy exists to dissipate the monopoly power without causing significant economic inefficiencies, is a crucial step in terms of assuring that whatever its source, the monopoly can now be abolished.<sup>113</sup> Such a case is inherently equitable and need not lead to a

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<sup>113</sup> In addition, a court tentatively persuaded that structural relief is in order might well ask either the Antitrust Division or the FTC to participate as an *amicus curiae* to advise the court on the merits of the proposed relief.

damage award at all.

It is not clear how far the plaintiffs' proof in *Johnson* went toward establishing a case of unlawful monopoly power because this claim was combined with a damage claim asserting abuse of monopoly position. For this abusive monopoly claim, the remediability of the monopoly would be irrelevant; it would be the abuse or misuse of the monopoly position that would trigger liability. However, some equitable relief might be in order where recurring abuse was likely. The standards for unlawful abuse could then be cast in quite strict terms since they would regulate only the conduct of a monopolist whose position is not challenged.

#### IV. Strategic Pricing Behavior in Nonmonopolizable Markets: The Rental Car Case

The *Johnson* case illustrates present judicial confusion in establishing standards to deal with the conduct of an actual monopolist. Regarding the basic presence of monopoly, the *Adjusters* case<sup>114</sup> stands in marked contrast. It is at least reasonably inferable that no firm could achieve an economically powerful monopoly within the replacement car rental market. Moreover, the accused monopolist was a new entrant whose competitive vigor drove one or two competitors from each of two markets. Yet the Court of Appeals for the Fifth Circuit evaluated the case as an attempt to monopolize both of these markets.<sup>115</sup> The case thus presented squarely the questions of whether, when, how, and why courts should, under the antitrust laws, intervene to review pricing conduct.

Regrettably, but hardly surprisingly, the decision in the *Adjusters* case ignored these vital questions. Instead, the Fifth Circuit's opinion addressed the problem of defining "average variable cost" with a lack of economic sophistication and understanding strikingly similar to the Sixth Circuit's failures in handling "average total cost."

##### A. The Adjusters Case

Within the broadly defined business of renting cars, there exists a specialized activity of renting cars to automobile insurance companies as temporary replacement cars for insureds. This business does not involve the high advertising costs and expensive storefront or airport lobby locations of general car renting.<sup>116</sup> It does require low prices and a specific ability to provide service to

114 *Adjusters Replace-A-Car, Inc. v. Agency Rent-A-Car, Inc.*, 735 F.2d 884 (5th Cir. 1984), *cert. denied*, 105 S. Ct. 910 (1985).

115 See text accompanying notes 140-46 *infra*.

116 735 F.2d at 886.

this specialized class of consumers.<sup>117</sup>

The *Adjusters* case revolved around a successful effort by a new entrant to drive its rivals from the market. The plaintiffs and the defendant, Agency Rent-A-Car, Incorporated. (Agency), were apparently all relatively new enterprises in this business. The plaintiffs had been the first entrants into several Texas cities. Agency subsequently entered two of those cities: San Antonio and Austin. After its entry, Agency made deep price cuts. These cuts concededly dropped Agency's prices below its "net operating" costs.<sup>118</sup>

Insurance company car rental decisions rest primarily on price, and the competing renters were unwilling to keep their prices at the low level set by Agency. Instead, they chose to drop out of this business.<sup>119</sup> The price cuts, therefore, established Agency as the leading insurance replacement car rental firm in both San Antonio and Austin. Agency's competitors sought revenge in a damage action against Agency, claiming attempted monopolization.

Both sides agreed that there were no technological barriers to entry in the replacement car rental business.<sup>120</sup> The essential capital ingredients were cars, an office, and a small staff. No heavy promotional or other intangible costs were present. Existing car rental companies and car dealers, moreover, had the basic knowledge, equipment, and ability to make entry. Finally, there do not appear to have been significant economies of scale.<sup>121</sup> The principal capital investment for such a business is in the cars themselves. Unlike many capital investments, however, if the cars are no longer useful in this business, they can, at relatively low costs and with little loss in value, be reassigned to other uses. This fact means that much of the capital investment in this specialized business can be recovered even if the business is not a success. This reduces both the perceived and the actual barriers to entry.<sup>122</sup>

There is no suggestion that the plaintiffs were less efficient than the defendant. In fact, the pricing data from San Antonio suggest that prior to the price war one of the plaintiffs, Adjusters, was able to operate successfully at prices lower than those which the

117 *Id.* at 886, 891-92.

118 *Id.* at 886-87.

119 Both competitors left the Austin market, but one remained in the San Antonio market. *Id.* at 887.

120 *Id.* at 893 & n.10.

121 Nothing suggested that there were rapid declines in average costs as volume rose, although presumably a few elements in staff size and minimum fleet scale might mandate a minimum scale. This is a reasonable inference from the cost data which suggests that in order to cover total cost, regardless of market share, certain rates were necessary. *See id.* at 891-92.

122 In contrast, an asphalt paving plant has only one economically valuable productive use and is costly to relocate. Hence, capital committed to the paving business is more at risk than that employed in auto rentals. *Cf. Johnson*, 729 F.2d at 1054.



defendant charged both upon entry and after it had excluded Adjusters from the market.<sup>123</sup>

Prior to trial, Agency admitted both that its prices were below cost and that its offices had "net operating" losses.<sup>124</sup> At trial, however, its accountant produced exhibits which allocated its costs on a daily basis between fixed and variable components.<sup>125</sup> On that basis, only \$3.65 to \$5.23 of its costs per car varied on a daily basis.<sup>126</sup> All other costs were "fixed" and did not vary from day to day based on the number of cars in use. Yet, Agency conceded net operating losses when its prices were \$8.00 a day per car.<sup>127</sup> This means that less than half and perhaps as little as one-third of its costs were "variable"; the rest were fixed.<sup>128</sup> Such ratios imply a large capital investment relative to operating costs.

The plaintiffs' lawyers objected to this "evidence" as contradicting a prior unambiguous admission.<sup>129</sup> They did not produce their own cost allocations or challenge the defendant's methodology but relied on their purely legal objection.<sup>130</sup>

As will be discussed later, plaintiffs could have disputed the defendant's labeling process and stressed the tension between an accounting approach to costs and an economic one. They could also have created a jury issue as to the appropriate measures of variable cost.<sup>131</sup>

The accountant's price-cost analysis does not explain the rationality of the defendant's conduct. Having shown that the defendant consciously chose to operate at prices below its long-run costs in a market with low entry barriers, the interesting business and economic question is, and the appropriate legal issue should be, why that should have been rational conduct for the defendant. Only after answering that question does it make sense to decide on legal standards or evaluate the cost-price calculations.

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123 735 F.2d at 886.

124 *Id.* at 891.

125 *Id.*

126 *Id.*

127 *Id.* The plaintiffs contended that Agency had net operating losses even at prices of up to \$9.50 a day. *Id.* at 886.

128 The range depends on what costs are taken to represent total as well as variable costs. Using the lowest variable and highest total costs, the ratio is one-third. The smallest possible ratio is about two-thirds.

129 735 F.2d at 891-92.

130 *Id.* at 892-93.

131 All commentators recognize that there are serious definitional problems in particular cases. At least in some cases, the courts have held such disputed issues present jury questions. See, e.g., *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014, 1036-38 (9th Cir. 1981), *cert. denied*, 459 U.S. 825 (1982).

### B. *Price Cutting as Business Strategy for a New Entrant*

In order to understand business behavior it must be put in context. The traditional microeconomic analysis of price assumes a situation of equilibrium in which supply and demand are in harmony. New entry into a market will, by definition, disrupt such an equilibrium and cause a dynamic readjustment of supply and, potentially, demand.

To achieve successful entry, the new firm may need, for a variety of reasons, to offer its goods below any measure of cost. Such pricing is not necessarily invidious. It is part of the cost of entry. In fact, the firm should capitalize the losses thus incurred as part of its total cost to be amortized over time. That is, the firm should be predicting that in the future its price-to-cost ratio will be sufficiently favorable to compensate for the earlier expenses plus interest on that investment.

Such an analysis does not imply that an entrant is expecting a "monopoly" profit. The reasons for low prices relative to costs on entry include (individually or in combination) (1) compensating buyers for taking the risk of buying a new product; (2) expanding demand to a level which will allow the entrant to achieve scale economies; and (3) keeping prices at competitive levels, expecting costs to decline because of the "learning curve" phenomenon.

Inducing a change in the source of supply can impose risks and costs on customers. The primary risk is that an unsatisfactory product will bring losses to the buyer. The primary cost is in assessing the new product to determine its comparability to the old. A new entrant can, by a deep price cut, offer partial compensation to the customer for those risks and costs. Thus, short-term price cuts, even below average variable cost, can be rational devices for firms which do not expect to foreclose entry or dominate industry prices.

Second, if demand is price elastic, keeping prices low may generate the volume necessary to achieve economies of scale in production, reducing costs so that the prices become profitable. The low price would be relatively permanent and sales volume must expand to reduce per unit costs over time.

Third even if, a firm expects a highly competitive market, does not expect any particular scale economies, and expects that its costs will initially exceed its prices, still it may be economically rational to enter the business. New entrants can have significant start-up costs. In addition, workers and managers will at first be slow and relatively inefficient producers, resulting in high per unit costs. As employee skills develop and managers learn how to speed up the production process, costs per unit will drop. This phenomenon is called the "learning curve." It reflects the dynamic cost-effects of

experience. If such direct costs will drop substantially in relation to price, it will be entirely rational for a firm to enter the market, despite its knowledge that its initial variable costs will exceed its present and future prices.

There is, of course, an alternative, less wholesome explanation for such pricing conduct. A deep-pocket entrant, recognizing that existing competitors have limited staying power and believing that a reputation for vigorous price cutting will deter future entry, might elect to enter a market and foreclose present and future competition by its pricing conduct. This would be rational only if the price-cutting entrant expected at a future time to have sufficient power in the market to raise its prices and recover its initial losses.

Such exclusionary pricing conduct would be irrational if entry is relatively easy. If the price increase needed to compensate for the losses due to the price cuts would induce new entry, cost-recovery would be impossible.<sup>132</sup> The need to recover costs, therefore, defines a limit to such pricing conduct. A rational entrant contemplating such exclusionary pricing should calculate those costs, capitalize them, and identify the size and duration of the price increase needed to earn back that sum. If the payback period is relatively short and the needed overcharge relatively small, the benefits can exceed the costs even with relatively low barriers to future entry.

While such predatory entry is manifestly anticompetitive, it is not clear that the courts ought to review every instance in which such motivations might explain low pricing by an entrant. Where the prospective future monopoly is not powerful, the social loss is not great. Moreover, as a practical matter, it may be very hard, if not impossible, to determine the business purposes behind particular price decisions. This would be especially true in cases in which the argument for low prices is that they are needed to compensate customers for risks or other costs or where there is a claim that a learning curve could be stimulated with a consequent reduction in costs.

Differentiating such excuses for short-run low prices from purely exclusionary price cuts would be very difficult. These difficulties in turn could provide existing firms with a legal club to attack any new entrant which used vigorous price competition. It is indeed for these reasons that the common law tort analysis of unfairly low prices has floundered.<sup>133</sup>

The *Adjusters* case illustrates the ambiguities inherent in review-

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132 See, e.g., Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981); McGee, *Predatory Pricing Revisited*, 23 J. L. & ECON. 289 (1980).

133 See notes 42-47 *supra* and accompanying text. See also *Katz v. Kapper*, 7 Cal. App. 2d 1, 44 P.2d 1060 (1935).

ing such nonmonopolistic new-entry price cutting.<sup>134</sup> Some evidence suggests noninvidious reasons for Agency's price cuts. Deep price cuts may have been necessary to get customer acceptance.<sup>135</sup> The alternative, exclusively exclusionary, theory of pricing also has some support in the evidence.

Using some of the cost and price data in the opinion, one can construct two cost-benefit analyses. First, accepting the defendant's cost data, which claimed average total cost of \$8 a day per car, the thirteen months of losing operation in San Antonio yielded approximately a \$315 per car total loss.<sup>136</sup> The subsequent prices would have yielded around \$2.45 a day above total cost. This is nearly a 25% markup over average total cost and would, on a per-car basis, pay back the predatory expense in a little over four months. Therefore, if the "predator" could get as little as six months or a year of car rental at such above cost prices, the initial investment would be well worth it.

A second calculation based on the plaintiffs' estimate of defendant's total cost, \$9.50 a day, suggests that the initial losses were much greater and that the above cost prices were only about 8% above total cost. The resulting payback period would be nearly four years.<sup>137</sup> It is less likely that a successful price cutter could

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134 Agency offered no explanation for its conduct. It merely contended that its conduct did not violate a doctrinal guideline: pricing below average variable cost. See 735 F.2d at 891. The plaintiffs similarly focused on this issue, construing the defendant's admissions as conclusively demonstrating the point. *Id.* at 891-93.

135 The price data from San Antonio showed that Agency was unable to acquire any substantial business after its entry when its prices were a dollar above and then fifty cents a day below Adjusters' prices. *Id.* at 886. Only when the price was a dollar and a half a day below its more established competitors did it receive significant business. It then retained that business as it raised prices to \$9.50 a day, despite its competitors continued presence in the market. It raised its prices further only after those competitors had exited.

The pricing sequence in Austin was different. Agency entered with price of \$7 per day which was substantially below that of its competitors and only after having driven its competition from the market did it raise its price to \$10.45. Agency's entry into Austin came a year after its entry into San Antonio, and one could easily infer that Agency had determined that only a deep price cut would cause insurance companies to change car rental sources. This would mildly contradict the assertion that price alone determined choice of rental car.

136 735 F.2d at 886-87. The total cost is calculated by assuming a 30-day month, and also by assuming that various price changes came at the beginning of the month in question. On that basis, there were eight months in which Agency lost \$1 a day (cost = \$8, price = \$7) and another five months in which it lost fifty cents a day (cost = \$8, price = \$7.50) yielding a total, per-car loss of \$315 for the period from March 1975 through March 1976 during which its prices were below \$8. The payback was calculated using Agency's Austin prices of December 1977 of \$10.45 a day. The highest price quoted for San Antonio was \$9.50 during the last period of competition. At \$9.50, the direct cost-payback period would be seven months.

137 The plaintiffs claimed that defendant's total costs were \$9.50 a day which would lengthen the period of loss and increase its severity. The loss period in San Antonio grows to twenty months and the total loss per car becomes \$1,060. The payback at \$10.45 falls to less than \$1 per car per day and so the period grows to about four years to recover all losses, before any interest or carrying charges are recovered.

enjoy four years of above cost pricing. But, on the other hand, if the markup is a modest 8%, that may make new entry far less attractive given the significant short-run costs that any new competition would have to incur.<sup>138</sup>

Both sets of calculations rest on very precarious assumptions.<sup>139</sup> They are offered only to illustrate that it might have been rational for a firm in this business to charge low prices solely to exclude competitors. It is ironic that the defendant's cost calculations provide the stronger case for such conduct. In addition, the defendant's assertion that a relatively high proportion of all costs were fixed would justify a conclusion that new entry could be more easily deterred. Even though the technological barriers were low, especially to existing car rental firms, the high fixed costs would make entry more risky so long as the entrant believed that the established firm had the resources and will to fight back. In such a case, the entrant would lose the earnings on its substantial investment which, *ex hypothesi*, is the major cost of entry. This risk of loss exists even if the capital could be redeployed without cost at a later date. That Agency, after eliminating its competition, could charge a 7.5% to 20% premium above total cost and not confront new competition is some confirmation of this entry barrier analysis.

I make no claim that the pricing strategy described in this case was in fact exclusionary. My analysis, however, does call into substantial question the black and white analysis of price-cost relationships which the courts have invoked. Prices either above or below variable cost may be rational for either anticompetitive or pro-competitive purposes in the context of new entry. This analysis also shows that the most relevant cost data at the point of entry is, in any event, total cost, and not short-run variable cost, since at entry all costs can vary. Moreover, the relevant time is not some short-run period of a day, week, or even month, but at least an intermediate, and more realistically, a long-run period in which the decisionmaker should look for revenue to justify and compensate for the costs of entry and operation.

### C. *The Fifth Circuit's Approach*

The Fifth Circuit's unanimous opinion rejected the plaintiffs' claim of attempted monopolization in the *Adjusters* case. It did so,

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<sup>138</sup> In defining markets for merger cases, the Antitrust Division Guidelines have suggested that a less than 5% price differential is so modest that even if a firm has the ability to change its prices by that amount, such a firm is not in a market distinct from producers who respond to price changes of 5% or more. See UNITED STATES DEPARTMENT OF JUSTICE, MERGER GUIDELINES (1984).

<sup>139</sup> They assume, *inter alia*, that demand is very price inelastic and that the same number of cars were in use before and after the low price period.

first, by converting economic analysis into almost ungrounded legal doctrine, and then, by making a highly questionable application of that doctrine.

First and foremost, the court's opinion accepts without question the proposition that a price below average variable cost constitutes an attempt to monopolize.<sup>140</sup> There is, to be sure, both precedent and scholarly assertions to that effect.<sup>141</sup> But why should a low price, however low, *ipso facto*, be thought to be an attempt to monopolize, let alone an unlawful one? If the concern of the attempt to monopolize prohibition is, as the Fifth Circuit has held in nonpredatory price cases, only with those actors whose existing and potential market positions threaten real and substantial monopolies,<sup>142</sup> then the findings of low entry barriers in *Adjusters* should have meant there was no case. Indeed, such a low entry barrier finding suggests that legitimate business reasons, such as those discussed earlier, could well explain Agency's pricing strategy, even if these were not the *only* reasons for its use. Such justifications, moreover, could well explain both below variable cost and below total cost prices.

The doctrine which the Fifth Circuit invoked arose in an analysis of the rationality of an established monopolist's deep cutting of its prices when facing new entrants. In such a situation, the probability that a below cost price has an exclusively anticompetitive explanation is very great. Moreover, the deeper the price cut, the greater is that probability. The situational and strategic background which is highly relevant to the rational economic and business analysis of such conduct drops away when the conclusionary definition of what is a predatory price receives a doctrinal acceptance. Thus, we shift focus, as the parties in this case did, from the analysis and explanation of conduct to an effort to fit specific price and cost data into a doctrinal category.

It is a nice irony that the issue degenerated even further into one concerning the validity of an apparent "trap play" by defense counsel who gave an admission which lulled the plaintiff into a false sense of security. The clearest implication of this case is that parties should focus on the cost accounting issues when a new entrant employs price cuts as part of its entry strategy. Neither the impossibility of achieving significant monopoly power nor the existence of legitimate business reasons for such pricing are apparently

140 *Adjusters*, 735 F.2d at 889.

141 See, e.g., *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 668 F.2d 1014 (9th Cir. 1981), *cert. denied*, 458 U.S. 825 (1982). See also *Areeda & Turner*, *supra* note 9; *Scherer*, *supra* note 2.

142 See, e.g., *United States v. American Airlines, Inc.*, 743 F.2d 1114 (5th Cir. 1984), *cert. dismissed*, 106 S. Ct. 420 (1985).

relevant.<sup>143</sup>

Despite the Fifth Circuit's emphasis on a doctrinal definition of predatory pricing, the panel failed to apply this economic doctrine adequately. The court did not inquire into the question of whether the defendant's cost allocation scheme satisfied the legal definition of variable cost. Given the court's list of Agency's investments, the defendant must have labeled as fixed, costs which varied over relatively short periods of time. The evidence on the ease of entry into the business strongly suggested that truly fixed costs, in an economic sense, were quite small. Cars, for example, were apparently treated as a fixed cost; but they can be quite variable for short periods of time given the many other uses which exist for them.

Moreover, given the particular context of this case, one can easily argue that, from an economic perspective, all of Agency's costs were variable because it was entering the market. At that point, it had *no* fixed costs because costs would only arise if entry occurred. In that context, entry and all of its associated costs would be rational only if expected total revenue would exceed expected total cost over time.<sup>144</sup>

The key legal, doctrinal question in *Adjusters* should have been whether costs which varied from day to day were the appropriate measure of the legally relevant "average variable cost." The court made no findings on this question and presented no reasons to justify its willingness to accept this cost calculation as the appropriate variable cost to use in applying its doctrinal rule.

There is a legalistic justification (suggested in a footnote) which acknowledged that cost issues frequently involve factual dispute and analysis.<sup>145</sup> The plaintiffs' case for below variable cost pricing rested exclusively on the admission of the defendant that its "net operating costs" exceeded its revenues. Given plaintiffs' duty to prove below variable cost pricing, all the defendant had to do was to tender some evidence, however questionable, that not all of its "net operating" costs were variable, and, absent additional evidence, the claim of below variable cost pricing would have failed.

In that event, the economically more correct position for the court of appeals to take would have been to hold that once a defendant proves that some fixed costs were included in the cost data given to the plaintiff, the plaintiff has the burden of proving it made

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143 This approach would also command a new entrant, having high initial costs but reasonably expecting those costs to fall as it moves along the learning curve, to charge very high prices at the outset, even if lower prices would yield greater volume, and consequently, increase the rate of cost reduction.

144 Posner argues that long-run marginal cost (which is equivalent to average total cost) is the proper measure of cost. R. POSNER, *supra* note 2, at 188-90, 239-40.

145 See 735 F.2d at 891 n.6.

reasonable adjustments to take account of fixed costs. This standard avoids the implicit and explicit problems found in suggesting that a daily variable cost figure is the most appropriate figure to use in defining legally relevant variable costs.

This is not to say that the result in the *Adjusters* case was wrong. Plaintiffs' lawyers waited until appeal to contest the defendant's cost analysis. Moreover, once a realistic assessment of the relevant market and its "monopolizability" is made, it is hard to take very seriously any major risk of market exploitation.

There remains a troublesome aspect to *Adjusters*, however. One of the plaintiffs was, at least in San Antonio, the *lower* cost operator in 1974. Although the data are very incomplete, the suggestion is that in a stable equilibrium it would have charged roughly a dollar a day per car less than its successful competitor. In context, this appears to be an 8% to 10% lower price. If a higher cost firm, by absorbing short-run losses of some degree, can in fact drive its more efficient competitor from the market and deter entry, the operation of an open, competitive economy is harmed, even if no significant monopoly results.

First, the firm which has greater productive efficiency is not rewarded with survival. The lesson is that being more efficient may avail very little indeed. This may not only deter desirable entry but it also suggests to firms that they find less efficient but less vulnerable ways to compete to retain market position.<sup>146</sup> Second, the price to consumers from all firms doing business may in some degree increase. The risk that a firm will be excluded, even if that firm is efficient, requires added compensation to justify its incurring the expense of competing. In addition, potential entrepreneurs and venture capitalists will not enter unless the potential reward is great enough to outweigh additional risk. Finally, an efficient competitor which is victimized in this way suffers an economic loss. Those who invested as well as those who labored in the enterprise suffer at least the costs of transferring their labor or capital to some other activity. If that new activity is a less profitable one, they also lose the better returns that a more optimal use of labor and capital would have produced.

#### D. *Two Legal Conceptions of the Fifth Circuit's Predation Rule*

Enough has been said to show that below cost pricing is not necessarily a tool of monopoly or those who would attempt a monopoly. One even suspects that the Fifth Circuit knew this. The

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146 Cf. Salop & Scheffman, *Rising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983); Schmalensee, *Entry Deterrence in the Ready-to-Eat Cereal Industry*, 9 BELL J. OF ECON. 305 (1978); Spence, *Investment Strategy and Growth in a New Market*, 10 BELL J. OF ECON. 1 (1979).



*Adjusters* case and its like are therefore not traditional attempt-to-monopolize cases. The price rules involved may imply an expansive definition of the attempt concept, one aimed at constructing rules of fair competition. They may even reflect and illustrate a federalization of the common law prohibition against unfairly low prices. But they do not constitute traditional section 2 type cases.

The first and most likely explanation for the general condemnation of below cost pricing is that the courts, unaware or heedless of the narrowly defined context of *Turner* and *Areeda's* concerns, have elected to use the criteria of static price theory to measure the fairness of prices in all contexts. This tort concept of unfair price competition is then incorporated into the Sherman Act in order to establish federal jurisdiction. Yet, neither step has been clearly recognized nor justified.

This explanation reveals why courts intervene in price wars as well as why they only condemn below variable cost prices. Basically, the static model of price declares that a price below variable cost is irrational in terms of the profit making, competitive firm. The model can only explain such prices as conduct aimed at a long-run gain. In the model, such gain will occur only if future monopoly profits exist. It is a truism of the common law unfair price competition analysis that low prices can unjustifiably eliminate equally efficient competitors from the market. The problem for the common law was identifying how low a price was too low. The economic model provides an apparent bright line answer. If price is below variable cost, it is bad.

The static price model also suggests that the only plausible explanation for such low prices is the expectation of a future monopoly. This justifies fitting these cases into section 2 of the Sherman Act and explains the policy rhetoric of the Fifth Circuit.<sup>147</sup>

This analysis is profoundly wrong headed, as had been suggested, because it ignores the dynamics of the market. Such bright line tests often produce irrational cut-offs. If the neoclassical assumptions are relaxed, prices emerge as flexible tools of real competition regardless of their short-run association with equally short-run cost measures. But a court using simple, static economic theory to guide its thinking may not want this kind of realism. Instead, the loose association with future monopoly can justify incorporating the below variable cost prices into the attempt to monopolize category without requiring that a monopoly be the likely outcome in any particular case.

The resulting rule is in reality a rule of "fair competition" which constrains the pricing freedom of all market participants. As

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147 See, e.g., 735 F.2d at 888-90.

such it may not be without value. Investigation of state minimum markup laws has, for example, suggested that such laws may impair harmful selective strategic pricing conduct and reinforce a strategy of generally low-priced competition.<sup>148</sup> The results in both structural and conduct terms seem to be desirable. Since such laws allow vigorous but cost-based pricing, they do not impair the vitality of overall competition. They do redirect pricing strategy and so will in some instances deny competitors the best strategy with which to compete.

In essence, the no-price-below-variable-cost rule of the Fifth Circuit is a more effective, but also less restrictive, version of the minimum markup law. It has a policy rationale, but it is at least questionable how closely that rationale relates to traditional monopoly or attempt to monopolize law. Moreover, unless the basis of this particular liability standard is distinctly recognized, there is a risk that in a case involving an actual monopoly or an actual attempt to monopolize, the courts will apply the same rules to test the legality of pricing conduct.

In the Fifth Circuit, there is an exception to the presumptive validity of an above variable cost price. Where barriers to entry are high, established competitors charging less than average total cost can be held liable.<sup>149</sup> This is a crude test to separate out real monopoly cases. The *Johnson* decision, however, suggests that this standard may be too generous toward potential or actual monopolists since in some cases above cost prices can still create or protect monopoly, and it does not differentiate between challenges to the lawfulness of specific prices and challenges to the lawfulness of the monopoly power itself.

Alternatively, one can explain the doctrine of outlawing all below marginal cost prices in terms of an expansive idea of attempted monopoly. Any increase in market power or position not justified by greater efficiency is a step toward monopoly with all its attendant costs. Below marginal cost pricing is a means by which such results can occur. If the presumption of such monopolistic effect is sufficiently strong, a court could reasonably demand that the user of any such price have a clear and convincing excuse. Hence, the apparent *per se illegality* of below cost pricing is in reality a strong *presumption* against such prices. A firm which offers as an affirmative

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148 See Cook, Deiter & Mueller, *The Effects of Wisconsin's Minimum Markup Law* (Staff Paper No. 62, Dept. Ag. Econ., Univ. Wisc.-Madison, May 1973); Paterson & Mueller, *State Sales-Below-Cost Laws: An Econometric Analysis of Effectiveness* (N.C. Project 117, Working Paper 79, Univ. Wisc.-Madison, Sept. 1984). See also T. Paterson, *Legal-Economic Analyses of Competition in the United States Food System* (Ph.D. Dissertation, Univ. Wisc. 1984). But see Waxman, *Wisconsin's Unfair Sales Act—Unfair to Whom?*, 66 MARQ. L. REV. 293 (1983).

149 See 735 F.2d at 893-94.

defense a showing that it had a nonmonopolistic business reason for its pricing strategy would win an acquittal. Such a defense is clearly consistent with the theories condemning "low prices" as attempts to monopolize.

The unarticulated theory behind this expansive version of attempt to monopolize law starts with a longer-run view of market structure change and posits that even efficient firms, unless very large, are vulnerable. Hence, dominant firms, which can survive more easily, have the opportunity by strategic, below cost pricing to alter market structure. The long-run preservation of a competitive market structure demands, under such assumptions, a strong prohibition of conduct which may needlessly concentrate markets. Early and strong judicial intervention—in the form of treble damages—is needed to deter such pricing conduct and preserve desirable market structure.

This theory ties into antitrust policy and echoes some of the analysis of older merger cases.<sup>150</sup> It is also predicated on assumptions frequently challenged by the "new" economic thinking,<sup>151</sup> and it certainly reflects an expansive definition of the "attempt" concept in monopoly law. One might wonder whether courts would endorse such a liability standard if they worked through, overtly, the steps needed to justify such intervention.

In sum, the rule of the car rental case fits only awkwardly within the general law of monopoly and attempted monopoly. The *Adjusters* court focused on applying a rule about illegal prices rather than inquiring whether any rule about prices made sense in the context before it. Despite its limited focus, there is a substantial question as to whether the court actually applied the economic analysis it said it wanted to use.

## V. Conclusion: The Future of Predatory Price Analysis in Monopoly Law

This article has identified and highlighted two crucial problem areas in predatory price litigation. First, a recurring theme of this discussion is the lack of direct and articulate linkage between the pricing conduct challenged as "predatory" and the section 2 prohibition on monopoly. *Prima facie*, the legal relevance of pricing depends on the legal theory of the case being pursued. Logically, if one wishes a monopoly declared unlawful and removed, the role and relevance of pricing conduct is very different than if one is claiming damages that resulted from a nonmonopolistic competi-

150 See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962).

151 See Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140 (1981).

tor's low prices. Similarly, a claim of unlawful use of monopoly position which is itself either invulnerable to legal challenge or not challenged, confronts a court with a third type of claim quite distinct from either of the first two.

It is essential to differentiate among the various possible legal claims and define the components of each. That process of definition will make evident the relevance of a price-cost analysis to each type of claim. Only then can courts, litigants, and commentators engage in rational policy debate as to which of the possible definitions of wrongful, "predatory pricing" should apply to each type of claim.

Such an analysis could eventually lead to adopting a uniform definition. But such an outcome seems unlikely unless courts were simultaneously to take a more tolerant view of structural monopoly itself or a less tolerant view of conduct by firms with some market power. In any event, a policy debate on the appropriateness of a single standard should focus on relevant legal policy questions such as which monopolies should be condemned and their power eliminated, which acts of monopoly should be torts subject to damage claims and whether that standard should vary based on the lawfulness of the monopoly power itself and/or on the party seeking relief and/or on the nature of the relief sought, and, finally, which acts of a firm, not yet in possession of a monopoly, should be condemned as wrongful for either injunctive or damage purposes. These are difficult policy questions to which there are no certain or easy answers. But these are the issues that ought to be addressed before courts resolve the question of defining the predatoriness of a price.

Second, lawyers and judges who propose to employ economic concepts must do so with greater care. One of the best known facts of economic analysis is that accounting data bears only an accidental relationship to economic concepts. Yet, in both cases under analysis, accounting data was *uncritically* used as evidence of the economic concepts employed.

The economist includes profit in total cost while the accountant does not. Hence, recovering accounting costs, including overhead, is not the same thing as recovering the average total economic cost. Similarly, variable costs include all costs which vary during a reasonable and relevant time period. A day is probably never such a period. Cost accounting on a daily basis bears no necessary connection to the economic concept of variable costs. In different contexts, longer or shorter periods will be more appropriate to the task of defining the relevant variable costs. Relevance in turn relates to the function of variable costs in defining appropriate

prices in a specific context. Thus, in some cases, as we have seen, only longer-run prices and costs are in fact relevant.

These quibbles are important, to be sure, only if classifying a price as above or below some abstract measure of cost is important. But if a court is going to treat such distinctions as vital, then the economics ought to be done correctly.

The case law to date is not inconsistent with the conclusion that "predatory pricing" is a red herring. Such a definitional exercise rests on the rather simplistic legal and economic assumption that there is a generic test for lawful prices independent of a carefully developed legal standard aimed at remedying one or more of the concerns of monopoly law, and unrelated to a careful review of the overall business context.

There is no shortcut past the problems of explaining why monopoly is objectionable (either in itself or because of its conduct) and, then, fitting the facts of the case to the specific objection made. If courts and litigants take these steps and face these problems, then, and only then, will the definition of the "predatoriness" of a price come from both the context and the theory of antitrust violation. Without this course, the label, except as a colorful term for a *conclusion* of wrongfulness, will in fact lack any independent legal or economic significance.